

**State of Washington  
Office of the State Treasurer**



**REPORT ON  
63-20 CAPITAL PROJECTS FINANCING**

**January 23, 2006**

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**Table of Contents**

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**CHAPTER**

EXECUTIVE SUMMARY.....	2
1. INTRODUCTION AND OVERVIEW OF KEY CONCEPTS.....	10
2. COMPARING 63-20 FINANCING PROCESS TO OTHER FINANCING CONTRACTS.....	15
3. COMPARING 63-20 STRUCTURE TO OTHER STRUCTURES .....	24
4. COMPARING 63-20 DEBT WITH AUTHORIZED STATE DEBT .....	27
5. INVENTORY OF 63-20 FINANCINGS .....	30
6. BENEFITS AND COSTS OF 63-20 FINANCINGS .....	31
7. IMPACT OF 63-20s ON ADMINISTRATION OF STATE OBLIGATIONS .....	43
8. CONCLUSIONS AND RECOMMENDATIONS.....	47

**APPENDICES**

- A. Comparison of Components of Lease Payments
- B. Comparing 63-20 Structure to Other Structures
- C. Inventory of 63-20 Financings from January 1, 2000
- D. Comparing Costs of Issuance
- E. Comparison of Costs of Tumwater Office Building Construction and Financing As a COP Project and the Actual 63-20 Project
- F. Excerpts from State of Washington Comprehensive Annual Financial Report, for the year ended June 30, 2005
- G. Boards of Directors of Washington 63-20s

# Executive Summary

## Background

*By requesting this report, the state Legislature has expressed its desire to understand the relative benefits and disadvantages of the state's borrowing methods.*

*The State Treasurer is interested in ensuring that all securities issued to finance state capital projects capture the lowest possible borrowing cost in the municipal market.*

Alternative capital project financing using IRS Revenue Ruling 63-20 (63-20s) gained the attention of the Washington Legislature in 2005. For many years, it has been the practice of the State of Washington to issue general obligation bonds and certificates of participation to fund state capital projects. After one state agency financed a building in 2004 using a 63-20 process, legislators indicated they wanted to take a closer look at the drawbacks and benefits of 63-20s.

This report has been prepared at the request of the 2005 Legislature, which directed the Office of the State Treasurer (OST) to convene a committee, with representation from each house of the Legislature, the Office of Financial Management, and an appointee of the Governor, to evaluate 63-20s and their financial implications. Although committee members provided guidance on the report, the recommendations provided herein are those of the State Treasurer, as directed, and may or may not reflect the opinions of all the committee members. The conclusions herein reflect our professional judgment.

The State Treasurer believes that the state should finance capital projects in a manner to capture the lowest possible cost available in the municipal market, while recognizing that financing costs are not the only costs to consider for a state capital project. This report's findings and recommendations reflect that primary focus. The State Treasurer and the committee members agreed on the importance of transparency in decisions about financing capital projects. The Treasurer encourages the development of data that can be used in making the best overall decision, which considers policy issues, construction costs and financing costs, among others.

*In 63-20 transactions, a nonprofit corporation issues securities (rather than the state being the issuer) to finance capital projects that will then be leased by the state.*

## Overview of 63-20s

The state traditionally funds new capital projects in Washington with a combination of cash and securities. Historically, the securities have been sold with the state as the issuer, in the form of general obligation bonds or certificates of participation. With 63-20 financings, a single-purpose nonprofit corporation is created in order to issue bonds. Using bond proceeds, the nonprofit funds the project and contracts with a developer for its construction. The

state then leases the completed building from the nonprofit<sup>1</sup>. Debt service on the bonds and other costs are covered by lease payments. At the end of the lease, which coincides with bond maturity, the state owns the building.

*There is some risk that a single-purpose 63-20 corporation may be treated as an alter ego of the state.*

To issue bonds on behalf of the state, a 63-20 corporation must receive express state approval of both the nonprofit corporation and its issuance of bonds. The State Treasurer believes all parties should be mindful of the risk that a single-purpose 63-20 corporation formed to carry out a specific financing might be treated in law as an alter ego of the state under language of the *State Building Authority* case (discussed in Chapter 2).

### **Purpose of the Report**

This report summarizes the results of an evaluation of 63-20 financings and makes recommendations to the Legislature about the future use of 63-20s for state agency public projects in Washington. Specifically, the report a) compares the 63-20 financing process with other financing contracts; b) compares the 63-20 financing structure to other financing structures; c) compares 63-20s to forms of authorized state debt; d) analyzes the cost/benefits of the 63-20 financing structures; and e) discusses the 63-20 impact on state debt administration. The Office of the State Treasurer surveyed underwriters, issuers and bond counsel in the state to inventory the 63-20 financings that have been completed since January 1, 2000. The report includes a listing of all reported 63-20 financings.

The report makes recommendations about the use of 63-20 financings by **state agencies** (other than research universities). **The report does not make recommendations about their use by local governments**, although the experience of some local governments is included for reference in the report. The report focuses on the financing aspects of 63-20s. It does not attempt to address issues outside the expertise of the Office of the State Treasurer and which should be studied by those with such expertise. For example, in the course of our evaluation it became clear that public works laws were a factor for some issuers when considering the use of 63-20s. We highlight the public works laws issues in the report. We do not make conclusions about their merit, but rather about the policy implications of how 63-20 financings are being used to avoid the constraints imposed by public works laws.

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<sup>1</sup> In the case where 63-20s fund student housing, the state does not lease the building(s).

## Findings

Based on the results of the survey distributed by the Office of the State Treasurer, there has been relatively limited use of 63-20 financings in Washington. Those public agencies that entered into such financings believe they benefited from the flexibility afforded by them. When examined, in most instances the flexibility arose not from the financing structure itself but from the project delivery method that can be accessed by public entities only via the private nonprofit corporation used in the 63-20 financing structure. We found the following:

- **Who is using 63-20 financings?**
  - Eight 63-20 financings have been reported as being completed in Washington since January 1, 2000.
  - The eight financings were undertaken on behalf of five public entities, including the state Department of General Administration (1); the University of Washington (3); King County (2); the City of Redmond (1); and the Highland Community Facilities Association (1).
- **Why are 63-20s being used?**
  - *They permit state agencies to construct state buildings with tax-exempt financing free from the constraints of public works laws* - In Washington, 63-20s appear to be used to avoid constraints imposed by the public works laws on a state agency if it uses the state's approved contracting methods. The limitations most often identified were: 1) inability to choose a design-build-finance (also known as lease-developer) project delivery method; 2) time constraints imposed by the legislative cycle; and 3) lack of certainty about the funding of ongoing building maintenance costs.
  - *They are perceived to achieve construction cost savings* - Some public entities that have used a nonprofit corporation to issue 63-20 bonds to finance capital projects report they are able to capture construction cost savings. There appears to be anecdotal information which may support the claim on a case-by-case basis. Unfortunately, data to support consistent construction cost savings has not yet been submitted. We were unable to find any reports measuring construction cost savings that would enable a reliable comparison of those savings against the higher financing costs with a 63-20 financing. A survey attempting to find reports which measure construction cost savings

*63-20 financings are being used in Washington, on a limited basis, primarily to free issuers from constraints of public works laws, and gain choice of project delivery method, flexibility in timing transactions, and a method to contract for ongoing maintenance, even if they ultimately pay higher financing costs.*

was distributed to 41 recipients in the state, but none of the recipients provided such information. This apparent lack of information is consistent with JLARC's report on Performance Audit of Capital Budgeting Processes, and its study of GC/CM project delivery (discussed later herein), which states that there is a lack of substantiating data on this topic.

- Risk is perceived to be transferred to the developer — Proponents of 63-20s report that 63-20 project participants benefit from a transfer of risk from the governmental entity to the developer. No quantitative analyses of the potential benefits of such a transfer were brought to the table for this study.
- **How do 63-20 financing and administrative costs compare to other forms of state debt?**
  - All participants in this report agree that, as a financing tool, 63-20s are more expensive than the state's traditional debt tools, in terms of interest rates, costs of issuance and ongoing fees.
  - Reporting and oversight to assure conformance to IRS and SEC regulations is not performed by OST, but is shifted to other agencies and private entities.

## Discussion of Findings

The Legislature has authorized contracting methods to be used by state agencies in the public works laws and, for a few *specific* state agencies, also in the alternative public works laws. These laws were drafted in part to provide a level playing field, to promote competitive bidding and to provide transparency. State agency projects conforming to these laws are financed with tax-exempt state bonds or COPs. While the use of the 63-20 financing method is legally available to state agencies, the Legislature has only authorized its use in the instance of the Tumwater Office Building. When the Tumwater Office Building was financed, proponents of the transaction claimed that certain benefits would accrue to the state because of the 63-20, including construction cost savings.

Committee members discussed the optimal goal — allowing a state agency to use both the lowest cost financing method **and** the lowest cost project delivery method, while following the policy directives that are embodied in the public works laws, such as competition and transparency. Members recognized that constraints imposed by current public works laws motivate agencies to participate in 63-20s, and thereby pay higher financing costs in order to access the lease-developer method.

*Clearly, good public policy dictates that a state agency should use both the lowest cost financing method **and** the lowest cost project delivery method, while following the policy directives that are embodied in the public works laws, such as competition and transparency.*

The private nonprofit used in a 63-20 financing to issue the securities is not subject to public works laws. Because public works laws do not apply, the 63-20 frees the state agency, through the nonprofit, to use *any* contracting method. The motivation for such use is that the contracting method should result in consequent savings in construction costs to offset the additional financing costs.

Extensive efforts were made to quantify the construction cost savings achieved by those public entities that have used 63-20 financing to access the lease-developer project delivery method. Several survey participants consulted national trade organizations and their own firms' municipal financing offices across the United States, but none were able to provide specific savings data. There were anecdotal reports about savings that were realized, but the question of whether the additional financing costs were consistently offset by the construction savings remains unanswered. In fact, the data received from GA indicates that the Tumwater Office Building lease payments were higher with its 63-20 financing and lease-developer project delivery than they would have been with COP financing and one of the other project delivery methods. (See Appendix E)

*Data received from GA indicates that the Tumwater Office Building lease payments were higher with its 63-20 financing and lease-developer project delivery than they would have been with COP financing and one of the other project delivery methods.*

In November 1993, the California Debt Advisory Commission ("CDAC") released guidelines for leases and Certificates of Participation, to be used by state and local agencies in California.<sup>2</sup> In its guidelines, CDAC states that "broad latitude over tax-exempt leasing decisions enjoyed by public officials can engender suspicion on the part of the public."<sup>3</sup> The guidelines include a discussion of various controversies that have occurred across the country relating to lease transactions. As a result, CDAC recommended that "Government agencies should implement procedures for soliciting public review and comment on tax-exempt leasing proposals."<sup>4</sup>

*Because no substantiating data has been revealed to determine whether accessing the lease-developer project delivery method can consistently provide construction cost savings that will offset the additional financing costs associated with 63-20 financing, the Treasurer believes it is premature to encourage state agencies to use 63-20 financings.*

Committee members grappled with similar concerns, the value of which was difficult to quantify. For example, with 63-20s much transparency is lost. This is a loss that concerned some committee members. What value should be placed on that loss? How can it be weighed against the claimed benefits?

Because no substantiating data has been revealed to determine whether accessing the lease-developer project delivery method can consistently provide construction cost savings that will offset

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<sup>2</sup> "Guidelines for Leases and Certificates of Participation," California Debt Advisory Commission - November 1993 (CDAC #93-8)

<sup>3</sup> *Ibid*, page 44

<sup>4</sup> *Ibid*, page 46

the additional financing and other costs associated with 63-20 financing, the Treasurer believes it is premature to encourage state agencies to use 63-20 financings.

Some characterize 63-20s as simply another form of financing lease, like COPs, which are authorized by RCW 39.94. But, in the case of 63-20 financings, this overlooks some important differences in the State Finance Committee approval process. Besides approving the financing lease, the committee must also 1) approve the nonprofit issuer, 2) approve the bonds being issued, and 3) agree to accept title to the building at lease end. The latter is necessary because during the lease the title to the building is held by the private nonprofit.

Without direction as to the process for the use of 63-20s, several questions remain unanswered, among them:

1. Should a public hearing be required, as with other alternative public works contracting?
2. Should the agency be required to specify where and how much potential construction cost savings it anticipates would be realized to offset the additional financing costs?
3. When should the Office of the State Treasurer, as administrative support to the State Finance Committee, be brought into the process to determine the difference in financing costs (which would also determine the minimum target of construction savings to be realized)?
4. When should the Office of the State Treasurer, as administrative support to the State Finance Committee, be brought into the process to review the financing documents which are unique to each 63-20?

The recommendations in this report attempt to address these issues.

### **Recommendations**

Good public policy mandates that a state agency maximize savings and minimize costs. That is, state agencies should be allowed to use both the lowest cost financing **and** the lowest cost project delivery method while maintaining important policy directives such as transparency and competition. Thus, the State Treasurer makes the following six public policy recommendations with respect to 63-20 financings:



## Financing Issues

*63-20 financings should be the financing mechanism of last resort.*

*Action is needed by the Legislature to require use of the COP program until construction cost savings from 63-20s can be shown to reliably offset their higher financing costs and....*

*... to adopt procedures for the use of 63-20s by state agencies under carefully monitored conditions that would yield performance data on the capture of construction cost savings.*

1. 63-20 financings should be the financing mechanism of last resort (used only under special circumstances, as determined by the State Treasurer in consultation with the Office of Financial Management), as they are more costly than general obligation bonds and certificates of participation, the most commonly issued forms of state securities.
2. The state Legislature should modify Chapter 39.94 RCW (regarding financing contracts) to require state agencies (other than research universities, as discussed in Chapter 2), that might otherwise turn to 63-20 financings, to fund their projects using the existing certificates of participation program unless sufficient independent quantitative analyses can be completed showing that the overall life-cycle benefits of using the design-build-finance contracting method exceed the additional financing costs.
3. If sufficient independent quantitative analyses are completed showing that the overall life-cycle benefits of using the design-build-finance contracting method exceed the additional financing cost, and a 63-20 is selected, the State Treasurer further recommends that the Legislature adopt procedures for the use of such 63-20s by state agencies that:
  - i. require early evaluation of proposed financing documents by the Office of the State Treasurer in its role as administrative support to the State Finance Committee,
  - ii. require a public hearing process similar to that required when an alternative public works contracting procedure is used<sup>5</sup>; and
  - iii. establish standards for using 63-20s, which includes factors such as requirements regarding identification of specific and sufficient potential construction cost savings to offset the additional borrowing costs, identifying which agency(s) is authorized to use 63-20s and the agency's need for specialized services.
  - iv. provide that, if 63-20 financings are authorized for state agencies, the Office of Financial Management, the Department of General Administration, the Office of the Attorney General, the Office of the State Treasurer and the State Auditor's Office perform oversight to

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<sup>5</sup> RCW 39.10.030(2)(a)(ii) specifies the process that must be followed by a public body wishing to use an alternative public works contracting procedure.

ensure compliance with all state and federal laws. Financing contracts for facilities entered into by one of the research universities and payable solely from nonappropriated facility revenues and not supported by general state revenues, would be excluded from these procedures.

*The State Treasurer recommends that the Legislature undertake research into the constraints imposed by public works laws and determine whether or not such laws should be modified*

*Judicial confirmation of state participation in 63-20 financings may be advisable.*

### **Public Works Issues**

4. Since state agencies are currently able to use 63-20s to free themselves from the constraints of public works laws, the Legislature should direct research into those laws to determine whether modifications are needed.
5. The Legislature should direct the preparation of a study to verify the claims of construction cost savings under the design-build-finance contracting method.

### **Constitutional Issues**

6. If 63-20 financings are authorized for state agencies, the State Finance Committee should consider the advisability of seeking judicial confirmation that the state's participation in 63-20 financings for state agency facilities is consistent with Article VIII of the State Constitution.

# Chapter 1: Introduction and Overview of Key Concepts

## Background

*This evaluation of 63-20 financings is being submitted by the Office of the State Treasurer, to comply with Chapter 488, Laws of 2005, Section 934.*

This report is being submitted to comply with Chapter 488, Laws 2005, Section 934, enacted during the 2005 Legislature. The State Treasurer is directed to convene a committee, with representation from each house of the Legislature, the Office of Financial Management, and an appointee of the Governor, for the purpose of evaluating the policy and financial implications of using Internal Revenue Service Revenue Ruling 63-20 transactions (63-20s) in Washington. The Treasurer was also directed to conduct an inventory of capital projects in Washington that have used 63-20s and to make recommendations to the Governor and the Legislature.

## Evaluation Method

*The State Treasurer, the Advisory Committee and staff undertook this report with a commitment to open and frank discussion on 63-20 financings, to ensure that differing perspectives were included in the dialogue.*

As required by Chapter 488, the State Treasurer assembled an advisory committee which met four times during the development of this report. Members of the Advisory Committee included Senator Karen Fraser, Senator Mike Hewitt, Representative Fred Jarrett, Representative Timm Ormsby, Mike Roberts (Senior Budget Assistant - OFM), and Thomas Gerlach (Turner Construction).

Staff to the committee distributed a survey to state bond counsel, financial advisors and underwriters. Survey responses were compiled into a list of 63-20 financings completed in Washington between 2000 and 2005 (see Chapter 5). Staff collected the Official Statements for each 63-20 financing that was identified in the survey. Staff interviewed individuals representing various entities in Washington who shared their knowledge and experience of 63-20 financings. Several market participants who have played a role in 63-20 financings made presentations to the committee. Finally, a survey attempted to obtain some hard numbers regarding construction cost savings with 63-20s and the lease-developer project delivery method.

## Report Content

The report summarizes the results of the evaluation and makes recommendations to the Legislature regarding future evaluation and use of 63-20 financings. Specifically, the report a) compares the 63-20 financing process with other financing contracts; b) compares the 63-20 financing structure to other financing structures; c) compares 63-20s to forms of authorized state debt; d)

analyzes the cost/benefits of the 63-20 financing structure; and e) discusses the 63-20 impact on state debt administration.

This report focuses on the financing aspects of 63-20s. In the course of our research, it became clear that issues surrounding public works laws were a factor for some issuers to use 63-20s. Although this report provides background information on public works laws, we have neither examined their effectiveness nor attempted to validate claims regarding limitations of those laws, as these topics are outside the expertise of the Office of the State Treasurer.

### **What is a 63-20?**

*A 63-20 financing is a form of financing lease, executed by a private nonprofit corporation and a public entity, in which the private entity issues bonds to finance a capital project on behalf of the public entity.*

Public agencies often issue general obligation or revenue bonds to finance capital assets. General obligation bonds pledge the full faith and credit of the issuer as repayment for the debt. Revenue bonds pledge a specific non-tax revenue stream, such as utility revenues or project operating revenues as the source of repayment. The amount of general obligation or revenue bonds that a public entity may issue can be limited by a number of factors, including legal debt limits, lack of debt capacity arising from revenue insufficiency, market access, and the voter approval process, among others.

Long-term leases provide public agencies with an alternative to issuing general obligation and revenue bonds. There are two types of leases available – vendor leases and municipal lease finance securities. Using a vendor lease, a public agency leases a capital asset directly from a vendor or leasing company, with the lessor receiving a portion of each rental payment as interest. This was the historical practice of Washington state agencies prior to the late 1980s, when the state lease/purchase program was created.

In lieu of a vendor lease, a public agency may utilize a tax-exempt lease in connection with the public sale of municipal securities. The issuer pledges undivided interests in the rental payments under the tax-exempt lease to repay the securities. The two primary types of municipal lease finance securities are certificates of participation and 63-20 financings.

*The Office of the State Treasurer developed the COP program to achieve several objectives, including exemption from the state debt limit, broad municipal market access, a competitive procurement process and conformance with open meeting and bid laws.*

- **Certificates of participation (COPs)** - State COPs were first authorized in 1989. The state's COP Program has standardized legal documents and a standardized financing structure and the COPs have broad market recognition. Because of this, the state's issues have access to underwriting firms nationwide – with the winner selected on a competitive bid basis.

With COPs, a public agency that undertakes a construction, renovation, remodel or acquisition project enters into a financing lease with a nonprofit corporation which serves as nominal lessor. We note here that the nonprofit corporation does not issue the bonds; rather, the public agency does so. The public agency either owns or acquires the property, which it leases to the nonprofit corporation under a site lease. The public agency then leases back the property with improvements (if any) through a financing lease, and those lease payments provide funds for payment on COPs used to pay project costs.

Under the state's program, the nominal lessor, currently the Washington Finance Officers Association (WFOA), assigns all of its right, title and interest in the financing lease and site lease to the state fiscal agent, acting as trustee. The fiscal agent executes and delivers the COPs that are issued by the state to fund the project costs. The proceeds of the COPs are held in a project fund in the state treasury pending disbursement by the State Treasurer to pay project costs. The public agency holds title to the property and improvements during the lease term.

*63-20 financings are bonds issued by a nonprofit corporation on behalf of a public agency.*

- **63-20 Financings** - 63-20 financings were first approved by the Internal Revenue Service in 1963. Such financings have been used in other states for parking garages, correctional facilities, hospitals, schools and some transportation projects. Under the 63-20 structure, 63-20 bonds are issued by a nonprofit corporation on behalf of the public agency pursuant to a trust indenture with a bank trustee. This issuance by the nonprofit differentiates the 63-20 financing from COPs, where the public entity is the issuer. The 63-20 bond proceeds are deposited in a project fund held by the trustee and used to finance the capital improvements (undertaken by the nonprofit corporation) that are leased to the public agency.

The nonprofit corporation, often through a private development company, designs and builds the project. The project may be operated and maintained either by the public agency itself under

the lease from the nonprofit corporation or by the nonprofit corporation through a management contract with a private management firm. Title to the project typically is held by the nonprofit during the life of the bonds. Title to the improvements is transferred to the public agency at lease maturity when the bonds issued by the nonprofit corporation are retired.

### **Project Delivery Methods for State Projects**

In the course of the 63-20 evaluation, it became clear that flexibility to choose the project delivery method is one of the main reasons issuers turn to 63-20 financings. To better understand the potential flexibility public agencies seek through 63-20 financings, it is helpful to briefly examine current state public works law.

When undertaking a capital project, Washington state agencies are subject to public works laws. Among other things, these laws specify the project delivery methods that may be selected by a public agency. So, whenever a state building is constructed, the agency must determine the best method of project delivery. Public agencies may use one of the following methods:

*In general, there are four methods of project delivery, three of which are available for use by state agencies, when the state is the debt issuer.*

- 1. Design-bid-build (DBB)** - The DBB method is considered the traditional method of project delivery. Under this approach, project design is completed by the public entity and an architect. Once design is complete, the construction contract is competitively bid and awarded to the low bidder.
- 2. Design-build** - When using the design-build method, the public entity bids out for, and selects, a single entity to complete both the design and construction of the public facility that will meet performance specifications for the desired project.<sup>6</sup> RCW 39.10.051 requires that contracts for design-build services be awarded through a competitive process utilizing public solicitation of proposals for design-build services. Evaluation factors include proposal price; ability of professional personnel; past performance on similar projects; ability to meet time and budget requirements; and ability to provide a performance and payment bond for the project, among others.
- 3. General contractor/construction manager (GC/CM)** - When using the GC/CM method, the public entity bids out and selects an architect to design the

project.<sup>6</sup> RCW 39.10.061 provides that the public entity separately procures a general contractor/construction manager, on a competitive proposal basis. Rather than selecting the general contractor on the basis of lowest price submitted, the entity bases its selection on qualifications, experience and price. The GC/CM works closely with the designer. At some point in the design phase (and this varies by public entity), the public owner negotiates the construction contract with the contractor.

There has been, and continues to be, debate in Washington about the adequacy and limitations of current state public works laws. Some issuers have turned to 63-20 financings as a means to avoid the limitations and to access a fourth project delivery method:

*63-20 financings are being used in Washington primarily to gain access to the project delivery method which is not authorized for use by public entities.*

#### **4. Design-build-finance (also called lease-developer)**

- The design-build-finance method is not available to public entities in Washington. However, the method can be used by a private nonprofit corporation created to issue 63-20 bonds, as such entities are not subject to state public works laws. According to GA, the Tumwater Office Building process was a competitive process among teams of non-profit facilitators and lease-development firms. The selection was a juried process.

*A 63-20 insulates the public entity from state public works laws, lending of credit, debt limit, and allows the contracting away of building management responsibility to capture savings which are estimated but difficult to quantify with certainty.*

Under this project delivery method, the private corporation negotiates with a single development firm to design and deliver the project, as well as to finance it. The developer then negotiates a construction contract with a single firm, which may subcontract for portions of the work. There is no requirement for a competitive bid, no lowest-price selection process, and no self-performance limit.

Essentially, by utilizing a private nonprofit corporation and the developer/contractor engaged by it to build the project, a 63-20 financing permits the public agency to gain access to powers that, while common in the private sector, are not available under state public works laws and/or to avoid certain restrictions that would apply under state law. The public agency causes the project to be acquired through the terms of its lease with the nonprofit corporation.

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<sup>6</sup> Not all state entities in Washington are permitted to use the Design-build and GC/CM methods.

## Chapter 2: Comparing 63-20 Financing Process to Other Financing Contracts

### Introduction

*The 63-20 financing process is similar to the issuance of Certificates of Participation.*

*Both COPs and 63-20s issued on behalf of state agencies are considered financing contracts and both must be approved by the State Legislature.*

*With one exception, all financing contracts issued by state agencies must be approved by the Legislature.*

As previously mentioned, 63-20 financings are a form of municipal lease, or financing contract. As such, the financing process for a 63-20 is similar to that of the more commonly used certificates of participation. For any state agency (with certain exceptions<sup>7</sup>), both financing methods require legislative approval and State Finance Committee approval. In addition, financing contracts require documentation and marketing materials; such documentation and marketing are more time-consuming for a 63-20 financing than for the state's certificates of participation. In this chapter, we describe the approval, documentation and marketing processes of both 63-20 financings and certificates of participation.

### Legislative Approval Process

Any financing contract entered into by a state agency under Chapter 39.94 RCW for the acquisition of real property must receive prior approval by the Legislature. The only exception is for financing contracts for research facilities, not supported by general state revenues, entered into by one of the state universities under Chapter 28B.140 RCW.

Under Chapter 39.94 RCW, a "financing contract" includes conditional sales contracts, financing leases, and lease-purchase contracts for the use and purchase of real or personal property and whose terms require them to be treated as financing or capital leases rather than "true leases" for accounting purposes<sup>8</sup>.

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<sup>7</sup> RCW 28B.10.022(2) permits the two state universities to enter into financing contracts that are payable solely from facility operating revenues not subject to legislative appropriation and not constituting general state revenues without prior approval of the State Finance Committee. In addition, RCW 39.94.040(4) permits the two state universities to enter into financing contracts for research facilities under the provisions of Chapter 28B.140 without prior approval of the Legislature.

<sup>8</sup> The Financial Accounting Standards Board website ([www.fasb.org](http://www.fasb.org)) provides the following summary of FASB statement no. 13 (Accounting for Leases): "This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For lessees, a lease is a financing transaction called a capital lease if it meets any one of four specified criteria; if not, it is an operating lease." These four criteria have been adopted by the State Finance Committee for the purposes of Chapter 39.94 RCW and are set forth in WAC 210-03-010. Those criteria are: (1) Present value of lease payments is greater than 90% of fair market value; (2) Lease term is greater than 75% of useful life; (3) Lease includes a bargain purchase option; or (4) Lease provides for transfer of ownership. Capital leases are treated as the acquisition of assets and the incurrence of obligations by the lessee. Operating leases ("true leases") are treated as current operating expenses.



Properly drafted financing contracts are not considered state *debt* and do not count against the state debt limit (See Chapter 4).

One of the requirements of a financing contract is that payments under the contract can be made only from currently appropriated funds or funds not constituting general state revenue.

Accordingly, financing contracts are special limited obligations that are payable solely from certain identified sources and subject to certain limitations, such as a non-appropriation clause. The limited nature of the obligation requires clear disclosure that it is not backed by the full faith and credit of the state.

If a state agency were to enter into a financing contract whose terms pledge the state's full faith and credit for payment or required the state agency in all events to pay the financing contract from general state revenues, then the financing contract would constitute state *debt* (see Chapter 4). Unless a financing contract having those terms was authorized by the Legislature in the manner required for any state *debt*, that financing contract would be legally invalid.

*Financing contracts are not considered state debt, because 1) they are not backed by the full faith and credit of the state, and 2) are not required to be paid from general state revenues or they contain a nonappropriation clause.*

However, if a financing contract does *not* pledge the full faith and credit of the state and is payable from funds *not* constituting "general state revenues," then it would not constitute state debt. This would include, for example, bonds or financing leases payable only from (1) fees and revenues derived from ownership or operation of any facility or project (such as housing, dining or parking system revenues of a state university), or (2) money received as grants, gifts or donations from federal agencies or other public or private persons, firms or corporations under terms requiring that money to be used for other than general state purposes (such as research grants and revenues received by the state universities).

Also, if a financing lease is payable from general state revenues, but the Legislature is *not* required to appropriate funds for its payment, then it does not constitute state debt under the narrow distinction drawn by the state Supreme Court in the *Department of Ecology* decision. Prior to the *Department of Ecology*, guidance was provided by *Washington State Building Financing Authority v. Yelle*, 47 Wn.2d 705 (1955). In *State Building Financing Authority*, the State Supreme Court held that the state's rental obligations to a state-created authority constituted debt. The court ruled that because the authority had to consult with the State Finance Committee before issuing bonds, it was essentially an alter ego of the state and its obligations could not be seen as anything other than state debt. 47 Wn.2d at 713. The *Department of Ecology* case distinguished the COP program under Chapter 39.94 RCW from the *State Building Financing Authority* structure on two bases.

One distinguishing characteristic in *Department of Ecology* was that under the terms of Chapter 39.94 RCW, the Legislature would never be required to appropriate sufficient funds to cover rental payments to the lessor, whereas the court in *State Building Financing Authority* noted that the Legislature was required to appropriate sufficient funds to cover the rental payments required under the leases to state institutions of higher education. 47 Wn.2d at 712-713. That distinction may exist both for COPs and for 63-20 bonds supported by a financing lease under Chapter 39.94 RCW, but only if the terms of the financing lease are properly structured.

The second distinguishing characteristic noted in *Department of Ecology* was that the lessor under the Chapter 39.94 financing lease program is not a state agency. 116 Wn.2d at 255-56. This might appear to be the same with respect to a 63-20 bond issue, but in order to issue bonds on behalf of the state, a 63-20 corporation must receive express state approval of both the nonprofit corporation and its issuance of bonds. There could be a risk that a single-purpose 63-20 corporation formed to carry out a specific financing for the state and approved by the State Finance Committee might be treated as an alter ego of the state under the language of the *State Building Financing Authority* case quoted above. By contrast, COPs are not issued by the Washington Finance Officers Association (currently the nominal lessor); instead, they are executed and delivered by a trustee to evidence and represent the state's payments of principal and interest components of lease payments under a financing lease that is subject to appropriation.

Consequently, a 63-20 financing for the state, including the terms of the underlying financing lease to the state agency, would have to be structured with great care to avoid being included in the constitutional debt limit.

### **State Finance Committee Approval Process**

Under RCW 39.94.040, following the legislative approval, the State Finance Committee (SFC) must approve the financing contracts entered into by state agencies. As noted above, state law provides an exception from SFC approval for certain financing contracts, not payable from general state revenues, entered into by the two state research universities. The SFC issues state bonds pursuant to Chapter 39.42 RCW and particular bond authorization acts passed by the Legislature. In addition, except as permitted under Chapter 39.94 RCW and with certain other limited exceptions, no lease for or on behalf of any state agency may be used or referred to as collateral or security for the payment of securities offered for sale through a public offering. RCW 43.82.010(4).

*With one exception, the State Finance Committee must approve both the issuance of state debt (bonds) and financing contracts (COPs and 63-20 financings).*

*In a 63-20 financing entered into by a state agency, the State Finance Committee approves both the nonprofit corporation and its issuance of bonds.*

*Policy questions on value of public works laws arise.*

Thus, all financing contracts entered into by state agencies in support of either COPs or 63-20 bonds, and all general obligation bonds, must be presented to, and approved by, the State Finance Committee. Materials presented for SFC approval include both legal documents (contracts and authorizing documents) and marketing materials (preliminary official statement).

The sole exception from SFC approval is for financing contracts payable solely from facility operating revenues not subject to legislative appropriation and not constituting general state revenues, entered into by one of the state research universities. (See footnote 8 above.) Instead, issuers such as the University of Washington are subject to approval by their own governing Board of Regents. Entities not subject to SFC approval have demonstrated in-house financial expertise and appropriate governing board oversight. The university's Board of Regents has approved a broad array of financing options (state general obligation bonds, COPs, university revenue bonds, 63-20s, lease revenue bonds through a conduit issuer such as the Washington Economic Development Finance Authority, and short-term credit lines) to ensure the development of key facilities.

### **Construction Contracting Process for State Projects**

As more fully described in Chapter 1, there are generally four project delivery methods available in the market. Only three of these methods can be used by state agencies.

Historically, Washington has used a design-bid-build (DBB) approach to public works projects.<sup>9</sup> In 1994, the state broadened the procurement rules relating to contractors (Chapter 132, Laws of 1994 -- RCW 39.10). RCW 39.10 now grants authority to certain public agencies to use the design-build or the general contractor/construction manager (GC/CM) methods of contracting, in addition to the DBB approach.

The design-build and GC/CM methods are often referred to as alternative contracting methods. The list of public entities that may use both methods is broad but not unlimited, and includes the Department of Corrections, the Department of General Administration, the University of Washington, cities and counties meeting certain revenue and population criteria, and certain public utility districts, port districts, hospital districts and school

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<sup>9</sup> Much of the information on contracting procedures is based on Report 05-09 entitled *An Assessment of General Contractor/Construction Manager Contracting Procedures*, published by the State of Washington Joint Legislative Audit and Review Committee (JLARC), (<http://www1.leg.wa.gov/JLARC/Audit+and+Study+Reports/2005/05-9.htm>).

districts, among others. The statutory authority to use the design-build and GC/CM methods is set to expire in 2007.

*The contracting method employed by users of 63-20s is the design-build-finance method, which is not authorized for use by state agencies under the public work laws and consequently cannot be financed by state general obligation bonds or COPs.*

The alternative contracting procedures authorized under state law require the state agency to engage in some form of competitive process in selecting the design-builder contractor, GC/CM or subcontractors. Under RCW 39.10.030(2)(ii), a public body wishing to use an alternative contracting procedure must submit a written statement of its reasons, along with other relevant information describing the project, and hold a public hearing. Critics of the state's current public works laws claim there are constraints, inequities or inefficiencies imposed by both traditional and alternative contracting methods that may lead to higher construction costs. For this reason, issuers have turned to 63-20 financings to gain access to certain flexibility or powers for public contracting.

*The nonprofit issuer of 63-20 bonds, as a private entity, is not subject to public works laws. If the state leases at least 50 percent of the building, however, it is subject to prevailing wage law.*

When a state agency participates in a 63-20, the project is financed by a private nonprofit corporation with 63-20 debt proceeds. By contrast to public agencies, which must use the DBB method, the design-build method or the GC/CM method, the private nonprofit corporation is free to select the design-build-finance method. It could be argued that the nonprofit corporation would not be bound by public bidding requirements, even if the project was expected to be leased to a state agency under a financing lease. This could be viewed as a possible advantage of using a nonprofit corporation to finance a project, but it raises policy issues for the state.

The public works laws were in part developed to ensure a level playing field, encourage competitive bidding and provide transparency. Subcontractors and their insurance/surety providers are reported to be concerned that GC/CM and lease-developer methods result in unfair risk transfers<sup>10</sup> to the small subcontractor.

On the other hand, under RCW 39.04.260, a project that the state causes to be constructed by a private party through a contract to rent, lease or purchase and of which at least 50 percent is expected to be used by one or more state or other public agencies is subject to the prevailing wage requirements of Chapter 39.12 RCW. Therefore, use of 63-20 financing for such a project does not avoid applicable prevailing wage requirements.

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<sup>10</sup> The reader is referred to the Capital Projects Advisory Review Board website, at <http://www.ga.wa.gov/CPARB/>, for materials relating to this topic.

## Documentation Process

*Unlike the standardized and market-recognized documents used by the state when it issues general obligation bonds or COPs, documents for 63-20 financings are tailored for each transaction.*

The state has standardized its legal and marketing documents for general obligation bonds and COPs. By contrast, documents used in a 63-20 financing are unique and tailored to a specific project. Instead of using standardized documents, participants in the 63-20 issue must negotiate terms and conditions in a project development agreement; the form of lease to the governmental entity; a management contract; and a trust indenture, among others. As mentioned in the Legislative Approval Process section above, it is important on several counts that the contracts be carefully drafted.

## Method of Sale

*Unlike state general obligation bonds and COPs, which are issued on a competitive bid basis, 63-20 financings are sold on a negotiated basis.*

When the state sells general obligation bonds or COPs, the winning bidder is that underwriting firm which submits the lowest responsive bid (the “competitive method of sale”). By contrast, when a 63-20 financing method is used, the underwriter is chosen early in the financing process. The cost of the bonds is determined on the sale date through negotiation with the underwriter (the “negotiated method of sale.”)

Academic reports reveal that studies have shown that the cost advantage of the competitive sale method over the negotiated sale method can be material. The table below<sup>11</sup> shows the level by which negotiated sales rates exceeded competitive sale rates, based on studies done from 1979 to 2001. Note that none of the studies concluded that negotiated sales were less costly.

Study	Negotiated Exceeds Competitive*
Joehnk & Kidwell (1979)	32 bp
Sorenson (1979)	26.5 – 42 bp
Mease (1985)	up to 76.7 bp
Simonsen & Robbins (1996)	29 – 53 bp
Leonard (1996)	(No difference)
Robbins (2000)	35 – 48 bp
Simonsen & Robbins (2001)	17-24 bp

*\*A basis point (bp) is 0.01%*

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<sup>11</sup> Simonsen, Bill, Mark D. Robbins, “Lessons from Research on Municipal Bond Issuance (PowerPoint)Simonsen, Bill, Mark D. Robbins, Lee Helgerson, “The Influence of Jurisdiction Size and Sale Type on Municipal Bond Interest Rates: An Empirical Analysis,” Public Administration Review, November/December 2001, 709-717.

As a result of such studies and other factors, many issuers are reconsidering their policies on the choice of sales method. The Government Finance Officers Association, an organization with 16,000 members involved with public finance, is also considering revising its guidelines to encourage fewer negotiated sales.

### **Service Providers**

The process of procuring service providers for a 63-20 financing differs from that of state bonds or certificates of participation.

*Property Manager* - Property management generally includes work related to maintaining the building, including janitorial functions, security, utilities and other basic operations.

When the state issues general obligation bonds or COPs to construct public facilities, those facilities are generally operated and maintained by the Department of General Administration. The state has both the expertise and personnel to perform property management. However, it may elect to contract for these services separately from the project financing.

*63-20 financings require the agency to hire private sector service providers to perform work that is normally done by the state when it issues general obligation bonds or COPs.*

*The state may have a separate desire to sign building management contracts with a corresponding reduction in state FTE counts for building services.*

A 63-20 corporation is not staffed to manage the property and typically contracts this out for a fee. For example, the Tumwater Office Properties, the name of the issuer of the 63-20 debt to finance the building, pays Wright Runstad (a private, for-profit company) to manage the property that is leased to the Department of General Administration. The Wright Runstad annual fee is \$0.75 per square foot, with an annual inflation factor of 2.7 percent.

*Nonprofit Facilitator and Developer* - A developer provides assistance in construction negotiations, financing negotiations, managing the disbursement of proceeds, inspections and oversight in readying the project for occupancy. A facilitator is an entity that has a group tax-exemption letter. It manages the process of establishing a single-purpose nonprofit corporation (which must have a public purpose) and appointing its board of directors.

When a state agency builds a project funded by general obligation bonds or COPs, there is no need for a facilitator because no single-purpose corporation is created. There is also no need for a developer because the Department of General Administration generally takes on the tasks of a developer. The state has both the expertise and personnel to develop the asset. GA charges the project management cost as an overhead expense to the project. Reasonable project management costs may be included in the amount financed for the project, at the agency's discretion.

For the 63-20s, there is both a facilitator and a developer. The Washington Tumwater Office Properties was created by the facilitator, National Development Council Housing and Economic Development Corporation (HEDC). In the case of most of the completed 63-20 financings in Washington, HEDC was selected as the nonprofit facilitator and the developer. The Board of Directors of the Tumwater Office Properties, as well as that of each of the 63-20 financings reported through the survey, can be found in Appendix G.

Public entities pay HEDC an upfront developer fee. In an interview, NDC indicated that the fee is negotiated on a transaction-by-transaction basis and ranges from 40-75 basis points (0.40 percent to 0.75 percent) of the total par amount of the bonds issued. However, fees for the Washington transactions surveyed were slightly higher, ranging from 75-100 basis points (0.75 percent to 1.00 percent) (see Chapter 6).

*Asset Manager* - Asset management generally includes work related to overseeing budgets, overseeing auditing and accounting, overseeing the property manager, and making sure debt service payments are made.

When the state issues general obligation bonds or COPs, it manages the asset through the work of several agencies. The state has both the expertise and personnel to manage the asset being built.

However, a 63-20 corporation is not staffed to perform the asset management function and typically contracts out these functions for a fee. With respect to the 63-20s done in the state, HEDC receives an ongoing fee for asset management. Annual asset management fees are typically 1 percent of rent or 1 percent of gross rent (see Chapter 6).

### **Lease Rates**

*Lease payments in a 63-20 financing are often used to provide for ongoing maintenance expenses.*

Comparing the underlying components of a lease payment helps identify where cost savings and additional expenses might arise. The fee or lease payment may include a rental component that is used to accumulate a fund for repairs and replacement (a “rainy day fund”), which mitigates the risk of deferred maintenance on the building. This practice differs from the standard process in Washington under which the Legislature has the authority to budget expenditures for maintenance of public buildings. The chart shown below highlights the key components of lease rates

and indicates how they are treated under the respective financing technique. A full-sized chart appears in Appendix A.

Comparison of Components of Lease Payments			
Components	Private Owner	63-20	COP
Local RE tax	Included	Not on tax rolls	Not on tax rolls
Overhead and Profit on Debt/ Asset Mgmt	Included	Included	Partially included
Overhead and Profit on Bldg Mgmt	Included	Included	Not included – GA handles
Fund for major capital repairs & replacements	Included	Included	Not included – GA / Leg determine
Maintenance	Included	Included	Not included – GA handles
Cost of obtaining financing (issuing debt or obtaining mortgage)	Low (mortgage fees)	Higher (unique contracts; more principals)	Mid (standard contracts; fewer principals)
Interest on loan *	Higher interest rate – taxable	Low – tax-exempt	Lowest – tax-exempt
Building			
Risk (presumably price is paid to shift risk)	Private	Private	State
Construction profit			
Bricks & mortar			
Labor			
Prevailing wage law applies	Yes if state has at least 50% of bldg	Yes if state has at least 50% of bldg	Yes
Subcontractor public work rules apply	No – private entity	No – private entity	Public work rules apply

\* Depends upon credit structure



## Chapter 3: Comparing 63-20 Structure to Other Structures

### Introduction

*The most significant financing structure differences between 63-20s, general obligation bonds and COPs are 1) state liability for debt repayment; 2) asset ownership during the lease term; and 3) security pledge.*

The structure of a 63-20 financing differs from general obligation bonds and certificates of participation in several important ways. The chart shown below illustrates some of the differences. A larger version of this chart can be found in Appendix B.

Comparing 63-20 Structures to Other Structures			
Feature	COPs*	63-20 Bonds	G.O. Bonds**
Lease term	Useful life of the property	Useful life of the property	Not applicable
Security	Lease payments	Lease payments	Full faith and credit of state
Non-appropriation risk	Yes	Yes	No
Ownership during lease	Public	Private	Not applicable
Ownership after lease	Public	Public	Not applicable
Control of financing	Public	Private	Public
Tax-exempt debt (if qualified under tax law)	Yes	Yes	Yes
Procurement process	State standards	Primarily exempt from state standards	State standards
Subject to debt limit	No	No	Yes / No (depending on authorization)

\*Certificates of Participation

\*\*General Obligation Bonds

Key differences are the state's legal liability for debt repayment, asset ownership during the term of the lease, and the security pledge for repayment of the obligation.

### State Legal Liability

*The state would still have some legal liability with a 63-20.*

The obligor on 63-20 bonds is the nonprofit corporation that issues the bonds, and such a nonprofit corporation is not a state or local government unit. In a typical 63-20 bond financing, the financed property would be leased to the state, and the state's lease payments would be used by the corporation to pay debt service on the corporation's bonds that are issued to finance the property. If the state has the exclusive beneficial possession and use of at least 95 percent of the financed property, the lease typically would require the state to pay all costs of operation, maintenance and

insurance for the property. In these circumstances, the state likely would have all of the substantial benefits and burdens of ownership of the property and be treated as the owner of the property for federal tax purposes, even if the nonprofit corporation were to retain legal title to the financed property, as in the case of 63-20s.

The state, as the lessee of the property, likely would have the ordinary liabilities of the project, such as those that would be covered under general liability insurance, as determined by the terms of the lease agreement.

### **Security Pledge**

*Financing contracts are limited obligations, payable solely from certain sources and subject to non-appropriation.*

Unlike general obligation bonds, one of the requirements of a financing contract is that payments can be made only from currently appropriated funds or funds not constituting general state revenue. Accordingly, financing contracts are special limited obligations that are payable solely from certain identified sources and that are subject to certain limitations such as a non-appropriation clause. The limited nature of the obligation requires clear disclosure that it is not backed by the full faith and credit of the state.

One of the key decisions in any financing other than general obligation bonds is what revenue is pledged to the debt repayment. Since neither COPs nor 63-20s are backed by the full faith and credit of the state and do not require that payments be made from general state revenue, another pledge of revenue is made. Various revenue sources may be pledged, including a dedicated fee or charge; revenue deriving from the operation of the project; or general revenues, subject to annual appropriation. Unlike COPs, 63-20 financings can be structured such that they are non-recourse to the issuer, meaning that repayment depends solely on project revenue. Depending upon the project, this pledge may create additional risk to repayment and sometimes that risk is reflected in lower credit ratings and higher interest costs on the 63-20.

### **Asset Ownership**

One difference between COPs and 63-20 Bonds is that during the lease term for a 63-20 financing, project ownership and control of the financing are held by a private entity. On the other hand, an agency participating in a COP has title, but there is a site lease lien interest that extends for five years longer than the financing term (to assure time is available to make good on payment to bondholders in the event where the agency fails to make timely debt service payments). As described in Chapter 1, the site lease is

momentarily held by the nominal lessor (currently, WFOA), and then is signed over to the fiscal agent acting as trustee. A Termination of Site Lease would be filed to remove the lien at the end of the financing period or when the lease is legally defeased.

## Chapter 4: Comparing 63-20 Debt with Authorized State Debt

### Debt in Washington State

Article VIII, Section 1(d) of the state Constitution defines state debt to mean borrowed money represented by bonds, notes or “other evidences of indebtedness” which are either (1) secured by the full faith and credit of the state, or (2) “required” to be repaid, directly or indirectly, from “general state revenues,” and which are incurred by the state, any department, authority, public corporation or quasi-public corporation of the state, any state university or college, or any other public agency created by the state. Under Article VIII, Section 1(i) of the State Constitution, the Legislature must prescribe all matters relating to the contracting of state debt by the favorable vote of 60 percent of the members elected to each house. With respect to obligations that constitute state debt, Article VIII, Section 1(j) of the state Constitution provides that the Legislature “shall provide by appropriation for the payment” of principal and interest on all such debt as it falls due, but in any event any court of record may compel such payment.

*To be counted as state debt requires a pledge of the “full faith and credit of the state” or a requirement that repayment be made from general state revenues.*

Section 1(d) of Article VIII goes on to clarify that obligations for the payment of current expenses of state government and certain other specific obligations, such as voter-approved debt, are not included under the constitutional definition of “debt.”

Accordingly, if the state borrows money and its repayment is backed by either the full faith and credit of the state or a requirement that payment be made from general state revenues, the state has contracted debt unless a specific constitutional exemption applies.

*Repayment of financing contracts can only be made from annual appropriations or from sources other than general state revenue.*

In addition to having the power to issue debt, Washington has the power to enter into financing contracts. Under Chapter 39.94 RCW, a “financing contract” includes conditional sales contracts, financing leases, and lease-purchase contracts for the use and purchase of real or personal property and whose terms require them to be treated as financing or capital leases rather than “true leases” (See Chapter 2) for accounting purposes. One of the requirements of a financing contract is that payments under the contract can be made only from currently appropriated funds or funds not constituting general state revenue. Accordingly, financing contracts are special limited obligations that are payable solely from certain identified sources and that are subject to certain limitations such as a non-appropriation clause. The

limited nature of the obligation requires clear disclosure that it is not backed by the full faith and credit of the state.

For a listing of state current obligations, please refer to Appendix F, which includes an excerpt from the State of Washington Comprehensive Annual Financial Report for the year ended June 30, 2005.

### **Debt Limit**

*Both the state constitution and statute limit the amount of state debt that can be issued.*

In addition to defining debt, the Washington State Constitution limits the amount of state debt, using a formula established by law. The amount of debt for which the state can contract is limited by Article VIII section 1(b) such that the “aggregate debt contracted by the state shall not exceed that amount for which payments of principal and interest in any fiscal year would require the state to expend more than nine percent of the arithmetic mean of its general state revenues for the three immediately preceding fiscal years as certified by the treasurer.” In addition to the debt limit set forth in the Constitution, there is also a statutory debt limit set forth in RCW 39.42.060 that prohibits the issuance of any debt that would cause the “aggregate debt contracted by the state to exceed that amount for which payments of principal and interest in any fiscal year would require the state to expend more than seven percent of the arithmetic mean of its general state revenues, as defined in RCW 39.42.070, for the three immediately preceding fiscal years as certified by the treasurer in accordance with RCW 39.42.070.” The definitions of “debt” and “general state revenue” are not exactly the same for the purposes of computing the constitutional debt limit and the statutory debt limit, but the basic concept is that the statutory debt limit was intended to be more restrictive than the constitutional debt limit.

*The Office of the Attorney General has opined that financing contracts, including COPs and 63-20s, are not subject to the state debt limit due to the state’s limited obligation.*

General obligation bonds are subject to the state debt limit. Certificates of participation are not subject to the state debt limit based on case law (the *Department of Ecology* case – see Chapter 2). With regard to 63-20 bonds, the Office of the Attorney General has opined that, assuming compliance with all of the requirements for issuing 63-20 bonds and for entering into and authorizing a financing contract in support of those bonds, the limited obligation created by a financing contract that supports 63-20 bonds is similar to the limited obligations created by financing contracts under which COPs are issued. As such, based on case law (*Department of Ecology*), 63-20s create a limited obligation that would be outside the definitions of debt authorized in Article VIII of the Washington State Constitution.

## Current State Obligations

*The state primarily issues COPs and general obligation bonds, which have broad name recognition in the municipal marketplace.*

The state's current obligations consist primarily of general obligation bonds and certificates of participation, although in unique circumstances revenue bonds have been used. The programs for the state's general obligation bonds and COPs are well-known in the municipal marketplace. Documentation is standardized and credit ratings are well-established. Because of this, the financings are sold on a competitive bid basis, whereby the underwriter offering the lowest interest cost to the state on the bond sale date is awarded the bonds/certificates.

*63-20 financings are considered "story bonds" and typically have no name recognition in the municipal marketplace.*

By contrast to the state's general obligation bonds and COPs, 63-20 financings offered for the benefit of Washington, each with its own newly established nonprofit issuer, are inherently not as well-known in the municipal market. This is not unique to Washington. Typically, 63-20 financings are known as "story bonds," in which the issuer is not yet known, or, as in the case of 63-20s, is created solely for the purpose of a single financing. The sole state financing completed as a 63-20 obligation during the period from 2000 to 2005 was a transaction to fund the costs to build the Tumwater Office Building<sup>12</sup>. The bonds were sold on a negotiated bid basis, whereby the underwriter was appointed early in the financing process.

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<sup>12</sup> The sole financing contract noted above does not include 63-20 financing contracts entered into by one of the state research universities where repayment is not from general state revenues.

## Chapter 5: Inventory of 63-20 Financings

### Inventory of 63-20 Transactions in Washington

The Office of the State Treasurer surveyed underwriters, issuers and bond counsel in the state to inventory the 63-20 financings that have been completed since January 1, 2000. The following table lists each of the reported financings, its purpose, sale date, and par amount. In addition, the table identifies the firms that participated in these completed financings. Although we include information on 63-20 financings completed by local governments, this report is directed only to the use of 63-20s by state agencies other than research universities. A larger version of this table can be found in Appendix C.

A total of eight financings have been completed since January 1, 2000, by five governmental entities. The University of Washington completed three 63-20 financings, King County executed two 63-20 financings, and the State Department of General Administration, the City of Redmond and the Highlands Sewer District each completed one.

As can be seen in the below table, one bond counsel firm, Preston Gates and Ellis, has served on every 63-20 financing in Washington during the period. One underwriter, Lehman Brothers, has served on seven of the eight financings; Bank of America underwrote one. Four different developers have been involved in the transactions. The boards of directors of each of these financings can be found in Appendix G.

63-20 Transactions from January 1, 2000 through August 31, 2005 Survey Results as of 9/28/2005							
Entity	Issuer	Purpose	Sale Date	Par Amount	Underwriter(s)	Bond Counsel	Developer
City of Redmond	Redmond Community Properties	City Hall	03/25/04	\$ 39,230,000	Lehman Brothers	Preston Gates & Ellis	Wright Runstad Associates
Department of General Administration	Tumwater Office Properties	State office building	01/07/04	56,805,000	Lehman Brothers	Preston Gates & Ellis	Wright Runstad Associates
Highlands Sewer District, King County	Highlands Community Facilities Association	Highlands Sewer District Project	12/14/04	4,450,000	Bank of America	Preston Gates & Ellis	The Highlands
King County	Broadway Office Properties	Land, office building and garage	10/24/02	62,540,000	Lehman Brothers	Preston Gates & Ellis	Opus Northwest
King County	Goat Hill Properties	Office building and garage	01/20/05	101,035,000	Lehman Brothers, Citigroup, Siebert Brandford & Shank	Preston Gates & Ellis	Wright Runstad Associates
University of Washington	Radford Court Properties	399 unit rental student housing project including surface parking and amenities	09/26/00	53,125,000	Lehman Brothers	Preston Gates & Ellis	Lorig Associates, LLC
University of Washington	University of Washington Alumni Association	Refunding of bonds initially sold in 1994 to acquire a building consisting of medical clinics, office facilities and underground parking	10/17/01	19,855,000	Lehman Brothers	Preston Gates & Ellis	N/A (Refunding)
University of Washington	25th Avenue Properties	146 unit rental student housing project including underground parking and amenities	03/12/02	34,085,000	Lehman Brothers	Preston Gates & Ellis	Lorig Associates, LLC

## Chapter 6: Benefits and Costs of 63-20 Financings

There was much agreement that 63-20s should be used only when any additional costs in the financing and issuance would be offset by even greater savings in construction costs. Members also discussed the importance of ensuring that a 63-20 is used only if the Legislature is comfortable with any forfeiture of the policy objectives for which the public works laws were established, such as a loss of transparency. In order to reliably weigh those costs and benefits, quantitative data is required.

To that end, staff both interviewed and surveyed issuers and other market participants in Washington and conducted independent research. Based on the conversations, research and survey responses, we were unable to obtain any data to support or refute whether or not 63-20s are consistently achieving their stated benefits of construction cost savings. However, all the market participants agree that the financing costs for the 63-20s are higher than those for general obligation bonds or COPs.

### Stated Benefits of 63-20 Financings

*The benefits stated by users of 63-20 financings derive from the project contracting and delivery method, and not from the financing structure.*

Based on interviews with the public entities in Washington that have used 63-20 financings, the most commonly stated benefits of 63-20s are those which arise from the project contracting/ delivery method, which is only available to the public entity because it has chosen to use a private nonprofit entity as the issuer. These benefits are discussed below.

*63-20 financings allow certain projects to proceed when the Legislature is not in session to approve projects.*

*Timing flexibility* - Agencies which are not required to seek legislative approval for certain financing contracts (see footnote 8) claim that one of the stated benefits of the 63-20 financings is that they permit the agency to take advantage of opportunities as they arise, without having to wait for the Legislature to convene and complete a financing approval process.

A University of Washington case study illustrates this benefit. In 1999, the university had the opportunity to acquire a medical research facility near campus. In order to be considered a credible buyer, the university had to demonstrate that it could get approval and close in a timely manner. Unfortunately, the opportunity arose while the Legislature was not in session, and the university was not able to wait until the next session for approval to issue general obligation bonds or COPs. By using a private nonprofit corporation to issue 63-20 bonds, the university did not need to wait for legislative approval. Instead, it sought Board of Regents approval for the use of a 63-20 financing.



*No reports were found to support or refute the claim that the project delivery method which can be accessed by using a 63-20 financing actually results in expedited project completion (except when related to Legislative approval as noted above.)*

*Expedited completion compared to conventional project delivery methods* - Proponents of 63-20s indicate that their use enables the public entity to expedite project completion as compared to project delivery methods authorized under state law. In Chapter 1, we identified and defined four project delivery methods.<sup>13</sup> Three of these methods can be used by most issuers of general obligation bonds and certificates of participation. However, the fourth method can only be used by an entity which is not subject to state public works laws, such as a private, nonprofit corporation.

A recent study released by the Joint Legislative Audit and Review Committee (JLARC)<sup>14</sup> examined the topic of expedited completion with respect to the state's use of GC/CM contracting. The JLARC report concludes that "...using the GC/CM contracting method can result in less schedule growth than DBB."<sup>15</sup> (p. 21) This supports the assertion that a non-conventional project delivery method may expedite completion when compared to the DBB method; however, the report does not address whether this is true of the design-build-finance method of project delivery.

None of the public entities that have used a nonprofit issuer to complete a 63-20 financing in Washington, nor HEDC or NDC, have presented reports showing a correlation between the financing structure and expedited completion, despite requests from the State Treasurer to submit such evidence. Based on our research, we have concluded that there is currently insufficient information to support or refute the assertion that the design-build-finance method expedites project completion. Moreover, we believe that if the benefit is indeed proven, it arises not from the 63-20 structure, but rather can be traced to the fact that the private issuer is not subject to public works laws.

*No reports were found to support or refute the claim that the project delivery method which can be accessed by using a 63-20 financing reliably results in lower construction costs.*

*Reduce project costs* - Proponents of 63-20s indicate that their use may result in lower overall project costs. This appears to be primarily made possible by the fact that the private nonprofit is not subject to public works laws. This difference allows the 63-20 issuer to 1) select the design-build-finance project delivery method that a state agency cannot; and 2) allows freedom in the selection of subcontractors. It may be noted that assertions of project cost

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<sup>13</sup> The four project delivery methods are (1) design-bid-build; (2) design-build; (3) general contractor/construction manager (GC/CM); and (4) design-build-finance (or lease-developer.)

<sup>14</sup> Report 05-09 entitled An Assessment of General Contractor/Construction Manager Contracting Procedures, published by the State of Washington Joint Legislative Audit and Review Committee (JLARC) June 22, 2005, <http://www1.leg.wa.gov/JLARC/Audit+and+Study+Reports/2005/05-9.htm>

<sup>15</sup> The report does point out that the GC/CM projects examined, similar to DBB projects, came in slightly over their planned schedules. (p 21)

savings have been made during a relatively low-inflation economic period, ranging from 2000 to early 2005, during which wage increases have been constrained and cost inflation has been moderate.

The JLARC study referenced above also examined the cost issue with respect to GC/CM projects. The report states that “without comparable claims data for DBB projects, it is not possible to conclusively determine whether the GC/CM contracting method results in (such) reduced costs.” (p. 3) The report concludes that “GC/CM increases preconstruction and, in some cases, management costs. Impact on change orders, claims and litigation is inconclusive.” (p. 28) Again, the JLARC study does not address the design-build-finance method of delivery.

None of the public entities that used a nonprofit issuer to complete a 63-20 financing in Washington, nor HEDC or NDC, has presented reports showing a consistent correlation between the financing structure and associated lease-developer project delivery method and project cost savings, despite requests from the State Treasurer to submit such evidence.

*The committee faced the difficult task of determining what weight to give to the anecdotal reports of cost savings.*

As a result the committee faced the difficult task of determining what weight to give to the anecdotal reports of cost savings. Indeed this was perhaps the most contentious point in the committee’s discussions. As always with anecdotal claims questions arise: How to generalize from a specific case? Were only the successful projects reported? Or, might the claims be unintentionally influenced by subjective evaluations – for example, a subjective perception that a more cooperative atmosphere existed which resulted in a claim that there was a reduction (but an unquantified reduction) in change orders?

Interestingly, GA provided information on change orders and claims history that could be used to quantify and compare target and actual benefits on the Tumwater Office Building from these sources. GA said that on Engineering and Architectural Services-managed projects “change orders were about 3 percent of the project cost and claims amounted to 0.6 percent of the project cost (on average).” This was consistent with other reports where the range of change orders was between 2 percent and 5 percent of project cost.<sup>16</sup> Since many proponents of the lease-developer project delivery method point to the reduction in change orders as

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<sup>16</sup> Staff research to provide perspective on cost of change orders found reports posted on websites sponsored by the California Department of Corrections that reported 2 percent to 3 percent on new projects and up to 10 percent on remodel and phased projects; Association for Facilities Engineering that reported 3 percent to 4 percent; Building and Construction Trades Department of the AFL-CIO that reported 2.08 percent; and National Real Estate Investors that reported nearly 5 percent of a project’s cost.

a significant source of savings, this allows a way of calculating some of the potential construction savings available to offset the higher financing costs. (For example, taking 3 percent of the Tumwater Office Building project costs gives us the expected cost of change orders: \$1.34 million. Similarly, for claims: \$267,000. If the lease-developer project delivery method could reduce change orders and claims to \$0, then a maximum target savings of \$1.6 million could be identified from these sources. Actual performance could be later measured against this projection.)

Currently, however, we found insufficient information to support or refute the assertion that the design-build-finance method reduces project costs. Moreover, we believe that if the benefit is indeed proven, it arises not from the 63-20 structure, but rather can be traced to the fact that the private issuer is not subject to public works laws. The committee believes the Legislature should direct research into those laws to determine if they should be modified. Again, the goal is to maximize total cost savings: ideally state agencies should be able to use both the lowest-cost financing and the lowest-cost project-delivery method consistent with the state's policy directives, such as competition and transparency. The committee also encourages the collection of data that would enable performance measures.

*Substitution of private resources and personnel for constrained public resources* - Nearly all of the 63-20 financings undertaken in Washington since 2000 have employed National Development Council. NDC is a 501(c)(3) nonprofit corporation which assists governments in exchange for a fee. NDC has a sister entity that operates as a single-asset corporation with a group tax-exemption letter. The sister entity is NDC Housing and Economic Development Corporation (HEDC). NDC and/or HEDC act as a developer and as an asset manager for public sector projects. NDC believes it brings value by providing professional expertise that may be lacking in the public sector, in areas ranging from project management to contract negotiations.

Normally, project development and asset management are handled by municipal employees. For example, the Department of General Administration provides these services for state agencies. However, smaller local issuers may not be adequately staffed. At least one of the users of the 63-20 financing (a local city) indicated that it lacked the in-house skills to manage the project development<sup>17</sup>.

It is only at the end of the lease, when the public agency acquires title to the building, that the adequacy and performance of the

*The committee encourages the Legislature to evaluate public works laws and require data collection that would enable performance measures on capital projects.*

*It is important that the project contracts grant the public agency an appropriate measure of supervision and control throughout the life of the project since the private party has no long term equity interest in the project to protect.*

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<sup>17</sup> Please note that the recommendations in this report deal with state agencies.

management and maintenance contracts can be fully evaluated. Indeed, one of the survey respondents provided a link to a website ([http://www.fhwa.dot.gov/ppp/dbfo\\_6320.htm](http://www.fhwa.dot.gov/ppp/dbfo_6320.htm)) offering a resource document with this advice: "...since in a tax-exempt transaction, the private party has no long-term equity interest in the project to protect, it is important that the project contracts grant the public agency participant an appropriate measure of supervision and control throughout the life of the project."

*The risk transfer benefits stated by public entities that have used 63-20 financings derive from the project contracting and delivery method, and not from the financing structure.*

*Risk shifting to private sector* - Proponents of 63-20s indicate that their use may shift risk to the private sector. There are several forms of risk to consider – construction risk, operating risk, building maintenance and default risk, among others.

The JLARC study, referenced above, examined the construction risk issue for GC/CM projects. The report concludes that "some owners may believe more risk is being shifted to GC/CM than is occurring." (p 23) With respect to construction risk, we note once again that the determinant of risk transfer is the project-delivery method and not the form of the financing. The key link is that the private nonprofit issuer is not subject to public works laws. The work being done by Capital Projects Advisory Review Board in investigating the fairness of the risk shift is encouraged. (See footnote 10 above.)

Perhaps more compelling is the risk transfer associated with the method of financing. If a project is financed using general obligation bonds or COPs, the public entity bears the risk of making debt service payments, regardless of the revenue generated by the project. However, under a 63-20 financing, the financing obligation may be structured as non-recourse. This means that the sole source of payment may be the project revenue or dedicated fee revenue, if applicable. Bondholders, rather than the state, bear the risk that there might be insufficient funds to repay the debt.

*Access to new sources of private capital* - Representatives of the University of Washington report they have used a 63-20 to enter into public/private partnerships for student housing. Lacking the resources to convert an existing building, the university was able to find a private developer to complete construction and to manage the housing. In this example, the university believes the financing structure lowered both its cost and financial risk. A university representative said 63-20 financings are used only when an enterprise revenue stream is available for repayment.

## Costs of 63-20 Financings

Besides higher financing and issuance costs associated with 63-20s, the committee received reports of other disadvantages including loss of transparency and loss of central administrative oversight. (The latter discussed in Chapter 7.) The committee also learned of some potential legal issues.

*63-20 financings are more expensive than general obligation bonds or COPs...*

Although financing costs are not the only project costs, they can be significant. Users of 63-20 bonds agree that the financing vehicle is more costly, both in terms of costs of issuance and interest rates. Costs of issuance are those costs which arise in bringing the securities to the marketplace, and include attorney fees, financial advisors, rating agency fees, and preparation and publishing of the official statements, among others.

*....with higher costs of issuance....*

*Higher costs of issuance* - A 63-20 financing leads to higher costs of issuance in various areas, including legal fees and rating fees, among others. By contrast to the standardized documents used by the state for general obligation bonds or COPs, documents in a 63-20 financing are tailored to the project and the transaction. This additional work leads to higher legal fees. In addition, non-recourse 63-20 financings can be viewed by rating agencies and investors as more complex and less secure than general obligation bonds or COPs. This is partly because the 63-20 property owner is a single-asset corporation. Since bankruptcy and corporate risk are characteristics of private companies, but not public entities, this leads to a weaker credit and the need for the rating analysts to spend more time reviewing bond documents.

The Office of the State Treasurer collected cost-of-issuance information on each of the 63-20 financings completed in Washington since 2000. The information was entered into the following table and compared to the cost of a hypothetical general obligation bond financing and a hypothetical COP financing, based on the state's published fee schedule and historical costs.

Costs of issuance are often compared on a "per bond" basis, meaning the cost per \$1,000 of bonds issued. For the 63-20 financings surveyed, total costs of issuance (including the underwriters' fee or "discount") ranged from \$19.38 to \$52.34 per bond. This is compared to an estimated \$7.33 per bond for general obligation bonds and an estimated \$13.65 per bond for COPs. The full-sized chart appears in Appendix D.

....with higher borrowing rates, and....

63-20s - Cost of Issuance and Underwriters Discount 63-20 Transactions from January 1, 2000 through August 31, 2005 (Dollar Amounts and Dollars per Thousand)							
Entity/Issuer	Par Amount	Underwriters Discount	Insurance	Cost of Issuance			Total Cost of Issuance and Discount
				Non-profit Upfront Fee	Other Cost of Issuance	Total	
City of Redmond / Redmond Community Properties	\$ 39,230,000	244,246 6.23	297,000 7.57	448,876 11.44	224,655 5.75	673,531 17.17	1,214,777 30.97
Dept. of General Admin / Tumwater Office Properties	\$ 56,805,000	298,226 5.25	- -	426,038 7.50	376,414 6.63	802,452 14.13	1,100,678 19.38
Highlands Sewer Dist., King Co. / Highlands Comm. Facilities Assn.	\$ 4,450,000	66,750 15.00	- -	- -	44,500 10.00	44,500 10.00	111,250 25.00
King County / Broadway Office Properties	\$ 62,540,000	279,491 4.47	458,000 7.32	469,050 7.50	801,900 12.82	1,270,950 20.32	2,008,441 32.11
King County / Goat Hill Properties	\$ 101,035,000	472,642 4.68	702,000 6.95	757,763 7.50	1,337,761 13.24	2,095,524 20.74	3,270,166 32.37
University of Washington / Radford Court Properties	\$ 53,125,000	363,800 6.85	1,699,849 32.00	398,438 7.50	318,219 5.99	716,656 13.49	2,780,305 52.34
University of Washington / UW Alumni Association (Refunding)	\$ 19,855,000	104,574 5.27	289,000 14.56	- -	163,111 8.22	163,111 8.22	556,685 28.04
University of Washington / 25th Avenue Properties	\$ 34,085,000	204,169 5.99	896,000 26.29	255,638 7.50	364,238 10.69	619,876 18.19	1,720,045 50.46
Office of the State Treasurer / COP*	\$ 50,000,000	350,050 7.00	200,000 4.00	- -	132,500 2.65	132,500 2.65	682,550 13.65
Office of the State Treasurer / Reimbursable Bond*	\$ 50,000,000	187,000 3.74	141,000 2.82	- -	38,500 0.77	38,500 0.77	366,500 7.33

\*Hypothetical issuance. Cost based upon average cost for the 01/01/2003 through 09/30/2005 period - all inclusive.

*Higher borrowing rates* - Market participants agree that the interest rates on 63-20 financings are higher than rates for general obligation bonds and COPs. Many industry participants believe that the trading differential reflects the difference in credit quality. In January 2004, 63-20 lease revenue bonds were issued by Tumwater Office Properties, a nonprofit newly formed on behalf of the state Department of General Administration to fund the Tumwater Office Building. At the time, it was acknowledged that the 63-20 financing could result in interest rates 30 basis points (0.30 percent) higher than rates on state COPs. The university estimates the same pricing differential (interest rates) for its 63-20 projects.

....with higher ongoing fees.

*Higher ongoing fees* - Unlike general obligation bonds or COPs, 63-20s include payment of ongoing asset management fees to a private corporation in the lease payment. For more conventional state issues, all work related to asset management is handled by the Department of General Administration. As can be seen in the chart below, the NDC/HEDC asset management fees are typically 1 percent of rent or 1 percent of monthly gross rent.

63-20s Nonprofit Ongoing Fees 63-20 Transactions from 01/01/00 - 08/31/05			
Entity	Issuer	Asset Manager	Ongoing Fees
City of Redmond	Redmond Community Properties	NDC*	Asset Management Fee equal to 1% of "Monthly Rent" and "Additional Rent"
Department of General Administration	Tumwater Office Properties	NDC*	Asset Management Fee equal to 1% of "Monthly Rent"
Highlands Sewer District, King County	Highlands Community Facilities Association	n/a	n/a
King County	Broadway Office Properties	NDC*	Asset Management Fee equal to 1% of "Monthly Rent"
King County	Goat Hill Properties	NDC*	Asset Management Fee equal to 1% of "Monthly Rent"
University of Washington	Radford Court Properties	NDC*	Asset Management Fee equal to 1% of "Gross Rent"
University of Washington	University of Washington Alumni Association	n/a	n/a
University of Washington	25th Avenue Properties	NDC*	Asset Management Fee equal to 1% of "Gross Rent"

\* National Development Council

*Overall Financing Impact of Interest Rates, Costs of Issuance and Ongoing Fees* - Although the individual difference in costs of issuance, interest rates and ongoing fees might appear small, the aggregate impact on a project can be significant. To illustrate the point, subsequent to the issuance by Tumwater Office Properties, the State Treasurer compared the actual 63-20 financing costs to a hypothetical state COP financing, using the established state fee schedule and historical borrowing rates. The State Treasurer concluded that if the financing had been completed as a COP, the estimated gross savings (assuming a level debt structure) would have been \$10.9 million (\$4.0 million net present value savings).

The Department of General Administration provided a comparison of the actual cost of the Tumwater Office Building versus the use of COPs. The comparison labeled "Comparison of Costs of Tumwater Office Building Construction and Financing As a COP Project and the Actual 63-20 Project," provided to OST on December 13, 2005, has been attached in Appendix E. **Note**

that the GA comparison shows that COPs would have been less costly than the actual cost of the 63-20, even after including the construction cost benefit. Specifically, the annual payment for a COP project would have been lower than the 63-20 as shown in the table below:

Assuming the Project Costs and Financing Costs Above - What Would Be The Annual Payments			
	COP Project Financed At Completion (Assuming \$52,330,000 "Project" Budget)	COP Project Financed At Inception (Assuming \$52,330,000 "Project" Budget)	Actual Tumwater Financing (Assuming \$52,330,000 "Project" Budget)
Excel Based Annual Payment over 25 years at Hattori Interest Rate Differences	\$3,837,111.34	\$3,932,197.60	\$3,956,802.51

Source: Department of General Administration

The annual difference totaled over the 25 years amounts to \$615,122.70 to \$2,992,279.19 in favor of COPs. The GA comparisons have not been verified by the committee or OST staff.

*Risk from Potential Legal Issues* – The loss of transparency is a potential legal risk in using 63-20 financings. This was mentioned in the response of Orrick, Herrington & Sutcliffe, LLP (a nationally recognized bond counsel firm) to the survey<sup>18</sup> (“the Orrick memo”) distributed by staff. Orrick points out that nonprofit corporations have broad powers. Unlike a public agency, the nonprofit issuer of a 63-20 financing “is not subject to open public meeting, public disclosure, competitive bidding, prevailing wage, public purpose, jurisdictional, or other restrictions on the exercise of their powers.” For public officials and citizens who rely upon these limitations to ensure transparency and an open process, their lack raises concern about state control over public projects.

The Orrick memo also alerted the committee to the possibility that a single purpose nonprofit issuer on behalf of the state might not continue to “observe the appropriate corporate formalities such as having required annual meetings...” The performance of these duties is outside the state agency’s control.

<sup>18</sup> Memorandum prepared by Orrick Herrington & Sutcliffe, dated December 21, 2005.



## Property Taxes

*Buildings financed under both 63-20s and COPs are exempt from state property taxes if, by virtue of the financing contract, the property can be treated as being owned by the state or local government unit.*

The Attorney General's Office previously has provided informal written advice<sup>19</sup> on the application of the state property tax to real property on which improvements are constructed with proceeds of 63-20 bonds or COPs where the property is leased under a financing lease to a state or local government unit. In general, it was concluded that, so long as the property is leased to a state or local government under a financing lease, including during the construction period, the property would be regarded as exempt property under RCW 84.36.010. That advice is summarized below.

*Title to land held by governmental unit* – If the land is owned by the state or local government unit and leased under a ground or site lease to a nonprofit corporation, which issues 63-20 bonds to finance a building on the land, and the land and building then are leased back to the state or local government unit under an absolutely net financing lease<sup>20</sup>, then the property (land and building) is treated as owned by the state or local government unit and exempt from property taxes.

The result is the same when the building is financed with proceeds of COPs in the financing lease of the state or local government unit rather than with proceeds of 63-20 bonds issued by the nonprofit corporation. RCW 84.36.010(1) specifically provides that "...all property under a financing contract pursuant to chapter 39.94 RCW...is exempt from taxation."

The property tax exemption would not be available during the period, if any, that the financing lease is not in effect, and the state or local government unit is not treated as the owner of the property. Also, the fact that the nonprofit corporation may manage the building under a management or service contract with the state or local government unit would not by itself affect this conclusion, depending on all the facts and circumstances.

*Title to land held by nonprofit corporation* - If the land is owned by a nonprofit corporation that issues 63-20 bonds to finance a building on the land, and the land and building is leased to a state or local government unit under an absolutely net financing lease, then the property (land and building) is treated as owned by the state or local government unit and exempt from property taxes even though title to the land is held by the nonprofit corporation.

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<sup>19</sup> Letter dated October 22, 1998, from Leland T. Johnson, Sr. Assistant Attorney General, Revenue Section, to Hugh D. Spitzer, Foster Pepper & Shefelman PLLC.

<sup>20</sup> We assume that the term "absolutely net financing lease" as used by the Attorney General in this advice referred to a lease under which the governmental entity is fully responsible for all costs and expenses of operating and maintaining the leased property, such as insurance, all utilities and taxes, if any.

The result is the same where the building is financed with proceeds of COPs in the financing lease of the state or local government unit rather than with proceeds of 63-20 bonds issued by the nonprofit corporation. RCW 84.36.010(1) specifically provides that "...all property under a financing contract pursuant to chapter 39.94 RCW...is exempt from taxation."

Again, the property tax exemption would not be available during the period, if any, that the financing lease is not in effect, and the state or local government unit is not treated as the owner of the property. Also, the fact that the nonprofit corporation may manage the building under a management or service contract with the state or local government unit would not by itself affect this conclusion, depending on all the facts and circumstances.

### **State Leasehold Excise Taxes<sup>21</sup>**

*State leasehold excise taxes may be found to apply to projects financed through a 63-20.*

*Ground or site lease to nonprofit corporation* - In most 63-20 or COP financings, the nonprofit corporation is obligated to pay only a nominal rent under the ground or site lease of the land on which a building is to be constructed. RCW 82.29A.130(8) provides an exemption for the leasehold excise tax where annual taxable rent is less than \$250.

More generally, in the circumstances described above under which the state or local government unit leases back the land and building under an absolutely net financing lease and therefore is treated as the owner of the property, the leasehold excise tax is treated as inapplicable because the only purpose of the ground or site lease is to function as an integral part of the financing transaction for the state or local government unit and not to provide substantive use of the property to the nonprofit corporation.

There has been neither legislation nor case law that gives direction on the applicability of the state leasehold excise tax to a private corporation which is involved, under a management agreement, in the management of a building financed through a 63-20. As such, Department of Revenue and county assessors may take the position that the leasehold excise tax would apply, and the Department of Revenue may impute a taxable contract rent that is

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<sup>21</sup> Under RCW 82.29A.030, the leasehold excise tax is imposed at the rate of 12 percent of taxable contract rent paid by nongovernmental persons for the use and occupancy of publicly owned real or personal property through a leasehold interest. Under RCW 82.29A.040, a county is authorized to impose a leasehold excise tax at a rate of up to 6 percent, and a city is authorized to impose a leasehold excise tax at a rate of up to 4 percent. The amount of any city tax is credited against any county tax, and both city and county taxes are credited against the state tax, so that the total tax on taxable rent in any such lease transaction cannot exceed 12 percent.

greater than a nominal stated rent under the ground or site lease, in circumstances where the nonprofit corporation uses its leasehold interest in the property for its own independent activities and derives revenue in amounts greater than reasonably necessary to defray the costs of financing and, where applicable, operation and management of the building constructed on behalf of the state or local government unit.

*Title to land held by nonprofit corporation* - In circumstances where the nonprofit corporation owns the land on which a building is to be constructed, and the land and building is leased to a state or local government unit under an absolutely net financing lease, the leasehold excise tax would not apply because there is no ground or site lease to the nonprofit corporation.

## Chapter 7: Impact of 63-20s on Administration of State Obligations

*The OST has policies and procedures in place to assure that the issuance of bonds and COPs conform to SEC and IRS regulations, including...*

To date, the Office of the State Treasurer (OST) has not played a role in 63-20 financings on behalf of state agencies except in its role as provider of administrative support to the State Finance Committee. As mentioned earlier, the State Finance Committee approves all state financing contracts (with the noted exceptions) and, in the case of 63-20 financings, also approves the nonprofit issuer and the bonds issued.

OST structures financings and provides ongoing administrative services only for general obligation bonds, revenue bonds and certificates of participation. There are several elements of state debt administration that should be considered in connection with the issuance of 63-20 financings. These are discussed below.

*.....reporting for the state CAFR;...*

*Tracking Outstanding Debt* - OST tracks general obligation bonds, revenue bonds and certificates of participation issued by the state for administrative purposes and compliance with federal tax and securities laws. OST reports on the outstanding bonds and COPs for the state CAFR. Outstanding obligations for 63-20s are not tracked by OST because the state is not the issuer. Appendix F contains excerpts from the state's CAFR for the fiscal year ended June 30, 2005, to illustrate the level and scope of the reporting requirements. Any state agency involved in a 63-20 financing would be required to independently report on the obligation (as a capital lease) for the CAFR.

*Due Diligence Process* - Due diligence includes reviewing all financial records and other information deemed material to the sale of bonds and COPs or other securities, and ensuring that such information is properly disclosed to the marketplace in a timely manner. The state has well-established administrative authorities and oversight rules in place for the issuance of COPs, general obligation bonds and revenue bonds, as well as for the performance of the state's due diligence. The decision-making process leading to a 63-20 and the review of related documents are not well-established in the state, other than the requirement for State Finance Committee approval.

*...tracking of bond and COP proceeds to assure that the tax status of the bonds is not questioned;...*

In addition to its disclosure of material information, the state confirms that the expected and actual use of bond and COP proceeds conform to state and federal law, including whether or not the use of bond and COP proceeds or bond and COP repayment gives rise to issues that may impact the tax status of such obligations. It is not clear how the ongoing use of proceeds

and bond repayment is tracked by a state agency that participates in 63-20 bonds.

*...tracking of arbitrage liability;  
and ...*

The state also performs periodic analysis on each bond and COP series to determine if there is any arbitrage liability (that is, investment earnings on bond or COP proceeds that exceed the level permitted by federal tax law and which must be remitted to the U.S. Treasury). It is not clear how arbitrage earnings are tracked by a state agency that participates in 63-20 bonds.

No review of these matters is performed by the Office of the State Treasurer on 63-20 financings, since the state is not the issuer. The responsibility and methods for administrative and oversight issues for 63-20s are managed by the individual state agency.

*.....primary and secondary  
market disclosure of outstanding  
obligations and material events.*

*Disclosure Requirements* - As part of the state's due diligence, OST performs primary and secondary market disclosure functions for general obligation bonds and COPs. Proper disclosure is essential and must be undertaken to comply with securities laws. Failure to properly disclose is considered a serious breach and may result in legal action being brought against the state by investors. If an official statement for the offering of bonds or COPs were to contain material misstatements or omissions, investors who purchase those obligations could assert securities fraud claims against the state for damages under federal securities laws. Repeated failures by the state to comply with its continuing disclosure undertakings in connection with the sale of bonds or COPs could result in potential underwriters of state obligations being unable to reasonably determine that the state's continuing disclosure undertaking will be effective, thereby precluding them from offering to purchase the state's obligations.

*Failure to comply with the SEC  
and IRS regulations may have  
serious and costly consequences.*

Disclosure includes preparing and disseminating Official Statements and continuing disclosure information (e.g., timely filing of annual financial statements and reporting of material events to Nationally Recognized Municipal Securities Information Repositories NRMSIRs). In preparing that disclosure for preliminary and final official statements, OST reports not only on outstanding bonds, but also on "Other Obligations." Under this section of the disclosure document, OST surveys and reports on the Workers' Compensation Program, the State Unemployment Compensation Fund, the State Retirement System, and Certificates of Participation/Financing Contracts. Besides reporting for the CAFR, any state agency that leases property under a lease properly treated as a financing lease under a 63-20 financing would need to prepare and submit reports on those financing leases in a timely manner to the OST so that material information about those obligations of the state can be included in official

*OST does not perform oversight  
and administrative services for  
63-20s; these roles must be  
undertaken by the state agency.*

statements prepared by the state for its regular bond and COP sales.

The nonprofit corporation as issuer of the 63-20 bonds would be required to make a continuing disclosure undertaking and to calculate and pay any arbitrage rebate amount and otherwise comply with arbitrage requirements. However, the state acting through the state agency, in its capacity as the sole lessee of the financed property and sole source of payment of debt service on the 63-20 bonds, presumably would be treated as an “obligated person” under SEC Rule 15c2-12, and therefore would have some continuing disclosure obligation in that capacity.

The Office of the State Treasurer performs no disclosure review for 63-20 financings. The financing team for the 63-20 is responsible for all reviews. The responsibility and methods for administrative and oversight issues for 63-20s are managed by the individual project issuer. It is possible that individual state agencies lack sufficient knowledge and experience to perform their due diligence roles related to the nonprofit’s issuance of 63-20s and in managing ongoing disclosure obligations. Such services may be performed by agencies, trustees, and other consultants.

*Fiscal Agent Services* - A fiscal agent, as paying agent, manages the transfer of monies for payments due to investors (bond holders and certificate holders). In addition, it serves as trustee for the financing leases and site leases associated with COPs.

Following an extensive competitive bid process, OST on behalf of the state negotiates a fiscal agent agreement (currently with the Bank of New York). The evaluation process includes assessing the bidders’ paying agent and other securities processing services, history of customer satisfaction and disaster-recovery plans. Additionally, OST requires a physical paying-agent presence within the state. Because the procedures for 63-20 financings have not been clearly defined, it is not clear whether the choice of paying agent for 63-20 bonds is, or should be, as exacting.

As previously noted, OST reports on the state’s outstanding bonds and certificates of participation. Part of that reporting includes reconciling OST databases to those of the fiscal agent. Again, because the reporting process for 63-20 financings has not been clearly defined, it is not clear whether a similar cross-checking occurs between the records of the state agency, the nonprofit issuer and the selected paying agent for the 63-20 bonds.

The state fiscal agent fee agreement extends to services provided to all public entities in Washington. Due to economies of scale, the fees charged to other public agency issuers within the state are

lower than might otherwise be achieved if they were to procure fiscal agent services independently. The nonprofit issuer of 63-20 bonds may be unable to take advantage of the state's fiscal agent agreement. However, it is possible that the nonprofit issuer would be treated as a quasi-governmental entity, and permitted to use the fiscal agent services.

## Chapter 8: Conclusions and Recommendations

### Conclusions

*63-20 financings are being used in Washington, on a limited basis, primarily to gain exemption from public works laws, which allows choice of project delivery method, flexibility in timing transactions, and a method to contract for ongoing maintenance.*

63-20 financings are being used in Washington on a relatively limited basis, primarily to gain exemption from public works laws, which allows choice of project delivery method, flexibility in timing transactions, and a method to contract for ongoing maintenance.

Eight 63-20 financings have been reported as completed in Washington since January 1, 2000. The eight financings were undertaken on behalf of five public entities, including the state Department of General Administration; the University of Washington; King County; the City of Redmond; and the Highland Community Facilities Association. Public entities that have entered into such financings believe they gained from the flexibility afforded by them. In most instances the flexibility pointed out by the issuer of a 63-20 arises not from the financing structure, but from the project-delivery method that can be accessed by public entities only via the nonprofit issuer in the 63-20 financing structure.

*The State Treasurer is interested in ensuring that all securities issued to finance state capital projects capture the lowest possible cost in the municipal market.*

As a financing tool, 63-20s are more expensive, in terms of both interest rates and costs of issuance. However, users are willing to incur the additional financing costs, as the 63-20s permit the public entity through the nonprofit issuer to avoid constraints imposed by the public works laws. The limitations most often identified were: 1) inability to choose a design-build-finance project delivery method; 2) time constraints imposed by the legislative cycle; and 3) lack of certainty about the funding of ongoing building maintenance costs.

The most commonly stated reason to use a 63-20 and the lease-developer method was to achieve construction cost savings. We were unable to find, and none of the participants in this report provided, any reports to substantiate or refute the claim that construction cost savings were consistently realized and so warrant the higher financing costs. Proponents of 63-20s report that projects benefit from the transfer of risk from the governmental entity to the developer. No quantitative analyses of this transfer were found.



## Recommendations

Good public policy mandates that a state agency maximize savings and minimize costs. That is, state agencies should be allowed to use both the lowest cost financing **and** the lowest cost project delivery method while maintaining important policy directives such as transparency and competition. Thus, the State Treasurer makes the following six public policy recommendations with respect to 63-20 financings:

## Financing Issues

*63-20 financings should be the financing mechanism of last resort.*

*Action is needed by the Legislature to require use of the COP program until construction cost savings from 63-20s can be shown to reliably offset their higher financing costs and....*

*... to adopt procedures for the use of 63-20s by state agencies under carefully monitored conditions that would yield performance data on the capture of construction cost savings.*

1. 63-20 financings should be the financing mechanism of last resort (used only under special circumstances, as determined by the State Treasurer in consultation with the Office of Financial Management), as they are more costly than general obligation bonds and certificates of participation, the most commonly issued forms of state securities.
2. The state Legislature should modify Chapter 39.94 RCW (regarding financing contracts) to require state agencies (other than research universities, as discussed in Chapter 2), that might otherwise turn to 63-20 financings, to fund their projects using the existing certificates of participation program unless sufficient independent quantitative analyses can be completed showing that the overall life-cycle benefits of using the design-build-finance contracting method exceed the additional financing costs.
3. If sufficient independent quantitative analyses are completed showing that the overall life-cycle benefits of using the design-build-finance contracting method exceed the additional financing cost, and a 63-20 is selected, the State Treasurer further recommends that the Legislature adopt procedures for the use of such 63-20s by state agencies that:
  - i. require early evaluation of proposed financing documents by the Office of the State Treasurer in its role as administrative support to the State Finance Committee,
  - ii. require a public hearing process similar to that required when an alternative public works contracting procedure is used<sup>22</sup>;
  - iii. establish standards for using 63-20s, which includes factors such as requirements regarding identification of specific and

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<sup>22</sup> RCW 39.10.030(2)(a)(ii) specifies the process that must be followed by a public body wishing to use an alternative public works contracting procedure.

- sufficient potential construction cost savings to offset the additional borrowing costs, identifying which agency(s) is authorized to use 63-20s and the agency's need for specialized services, and
- iv. provide that, if 63-20 financings are authorized for state agencies, the Office of Financial Management, the Department of General Administration, the Office of the Attorney General, the Office of the State Treasurer and the State Auditor's Office perform oversight to ensure compliance with all state and federal laws. Financing contracts for facilities entered into by one of the research universities and payable solely from nonappropriated facility revenues and not supported by general state revenues, would be excluded from these procedures.

*The State Treasurer recommends that the Legislature undertake research into the constraints imposed by public works laws and determine whether or not such laws should be modified.*

#### **Public Works Issues**

4. Since state agencies are currently able to use 63-20s to free themselves from the constraints of public works laws, the Legislature should direct research into those laws to determine whether modifications are needed.
5. The Legislature should direct the preparation of a study to verify the claims of construction cost savings under the design-build-finance contracting method.

#### **Constitutional Issues**

*Judicial confirmation of state participation in 63-20 financings may be advisable.*

6. If 63-20 financings are authorized for state agencies, the State Finance Committee should consider the advisability of seeking judicial confirmation that the state's participation in 63-20 financings for state agency facilities is consistent with Article VIII of the State Constitution.

**APPENDIX A**  
**COMPARISON OF COMPONENTS OF LEASE PAYMENTS**

Comparison of Components of Lease Payments			
Components	Private Owner	63-20	COP
Local RE tax	Included	Not on tax rolls	Not on tax rolls
Overhead and Profit on Debt/ Asset Mgmt	Included	Included	Partially included
Overhead and Profit on Bldg Mgmt	Included	Included	Not included – GA handles
Fund for major capital repairs & replacements	Included	Included	Not included – GA / Leg determine
Maintenance	Included	Included	Not included – GA handles
Cost of obtaining financing (issuing debt or obtaining mortgage)	Low (mortgage fees)	Higher (unique contracts; more principals)	Mid (standard contracts; fewer principals)
Interest on loan *	Higher interest rate – taxable	Low – tax-exempt	Lowest – tax-exempt
Building			
Risk (presumably price is paid to shift risk)	Private	Private	State
Construction profit			
Bricks & mortar			
Labor			
Prevailing wage law applies	Yes if state has at least 50% of bldg	Yes if state has at least 50% of bldg	Yes
Subcontractor public work rules apply	No – private entity	No – private entity	Public work rules apply

\* Depends upon credit structure

**APPENDIX B**  
**COMPARING 63-20 STRUCTURES TO OTHER STRUCTURES**

Comparing 63-20 Structures to Other Structures			
Feature	COPs*	63-20 Bonds	G.O. Bonds**
Lease term	Useful life of the property	Useful life of the property	Not applicable
Security	Lease payments	Lease payments	Full faith and credit of state
Non-appropriation risk	Yes	Yes	No
Ownership during lease	Public	Private	Not applicable
Ownership after lease	Public	Public	Not applicable
Control of financing	Public	Private	Public
Tax-exempt debt (if qualified under tax law)	Yes	Yes	Yes
Procurement process	State standards	Primarily exempt from state standards	State standards
Subject to debt limit	No	No	Yes / No (depending on authorization)

*\*Certificates of Participation*

*\*\*General Obligation Bonds*

**APPENDIX C**  
**INVENTORY OF 63-20 FINANCINGS FROM JANUARY 1, 2000**

63-20 Transactions from January 1, 2000 through August 31, 2005 Survey Results as of 9/28/2005							
Entity	Issuer	Purpose	Sale Date	Par Amount	Under- writer(s)	Bond Counsel	Developer
City of Redmond	Redmond Community Properties	City Hall	03/25/04	\$ 39,230,000	Lehman Brothers	Preston Gates & Ellis	Wright Runstad Associates
Department of General Administration	Tumwater Office Properties	State office building	01/07/04	56,805,000	Lehman Brothers	Preston Gates & Ellis	Wright Runstad Associates
Highlands Sewer District, King County	Highlands Community Facilities Association	Highlands Sewer District Project	12/14/04	4,450,000	Bank of America	Preston Gates & Ellis	The Highlands
King County	Broadway Office Properties	Land, office building and garage	10/24/02	62,540,000	Lehman Brothers	Preston Gates & Ellis	Opus Northwest
King County	Goat Hill Properties	Office building and garage	01/20/05	101,035,000	Lehman Brothers, Citigroup, Siebert Brandford & Shank	Preston Gates & Ellis	Wright Runstad Associates
University of Washington	Radford Court Properties	399 unit rental student housing project including surface parking and amenities	09/26/00	53,125,000	Lehman Brothers	Preston Gates & Ellis	Lorig Associates, LLC
University of Washington	University of Washington Alumni Association	Refunding of bonds initially sold in 1994 to acquire a building consisting of medical clinics, office facilities and underground parking	10/17/01	19,855,000	Lehman Brothers	Preston Gates & Ellis	N/A (Refunding)
University of Washington	25th Avenue Properties	146 unit rental student housing project including underground parking and amenities	03/12/02	34,085,000	Lehman Brothers	Preston Gates & Ellis	Lorig Associates, LLC

## APPENDIX D

### COMPARING COSTS OF ISSUANCE

<b>63-20s - Cost of Issuance and Underwriters Discount</b> <b>63-20 Transactions from January 1, 2000 through August 31, 2005</b> <b>(Dollar Amounts and Dollars per Thousand)</b>							
Entity/Issuer	Par Amount	Underwriters Discount	Insurance	Cost of Issuance		Total	Total Cost of Issuance and Discount
				Non-profit Upfront Fee	Other Cost of Issuance		
City of Redmond / Redmond Community Properties	\$ 39,230,000	244,246 6.23	297,000 7.57	448,876 11.44	224,655 5.75	673,531 17.17	1,214,777 30.97
Dept. of General Admin / Tumwater Office Properties	\$ 56,805,000	298,226 5.25	- -	426,038 7.50	376,414 6.63	802,452 14.13	1,100,678 19.38
Highlands Sewer Dist., King Co. / Highlands Comm. Facilities Assn.	\$ 4,450,000	66,750 15.00	- -	- -	44,500 10.00	44,500 10.00	111,250 25.00
King County / Broadway Office Properties	\$ 62,540,000	279,491 4.47	458,000 7.32	469,050 7.50	801,900 12.82	1,270,950 20.32	2,008,441 32.11
King County / Goat Hill Properties	\$ 101,035,000	472,642 4.68	702,000 6.95	757,763 7.50	1,337,761 13.24	2,095,524 20.74	3,270,166 32.37
University of Washington / Radford Court Properties	\$ 53,125,000	363,800 6.85	1,699,849 32.00	398,438 7.50	318,219 5.99	716,656 13.49	2,780,305 52.34
University of Washington / UW Alumni Association (Refunding)	\$ 19,855,000	104,574 5.27	289,000 14.56	- -	163,111 8.22	163,111 8.22	556,685 28.04
University of Washington / 25th Avenue Properties	\$ 34,085,000	204,169 5.99	896,000 26.29	255,638 7.50	364,238 10.69	619,876 18.19	1,720,045 50.46
Office of the State Treasurer / COP*	\$ 50,000,000	350,050 7.00	200,000 4.00	- -	132,500 2.65	132,500 2.65	682,550 13.65
Office of the State Treasurer / Reimbursable Bond*	\$ 50,000,000	187,000 3.74	141,000 2.82	- -	38,500 0.77	38,500 0.77	366,500 7.33

*\*Hypothetical issuance. Cost based upon average cost for the 01/01/2003 through 09/30/2005 period - all inclusive.*

**APPENDIX E**  
**(AS PROVIDED BY THE DEPARTMENT OF GENERAL ADMINISTRATION - 12/13/05)**

<b>Comparison of Costs of Tumwater Office Building Construction and Financing As a COP Project and the Actual 63-20 Project</b>			
<i>(Figures Rounded at \$100 - Excludes \$200,000 63-20 "Predesign" and \$300,000 estimated "Honrarium" for a COP)</i>			
<b>Project Costs</b>	<b>COP Project Cost Based on C100</b>	<b>Actual Tumwater Cost as a 63-20</b>	<b>Notes</b>
Acquisition Costs (Land)	\$1,777,300	\$1,777,300	Reversionary rights
Architectural & Consultant Services	\$3,747,400	\$3,024,200	
Changeover of tenant (WSP to DOC)	\$324,100	\$324,100	
Maximum Allowable Construction Cost	\$36,154,000	\$34,388,200	MACC \$1.2 million state share of savings shown on 63-20 project
Sales Tax	\$3,038,000	\$2,897,800	
Equipment	\$3,682,000	\$3,682,000	Furniture & equipment dollars currently in 63-20 budget
Retail Build Out & Solicitation	\$275,000	\$535,000	
Other Costs	\$1,311,000	\$2,601,700	
Project Management	\$2,071,600	\$1,848,100	
<b>Total</b>	<b>\$52,380,400</b>	<b>\$51,078,400</b>	

<b>Assuming \$52,330,000 Financing - What Are the Financing Costs</b>				
<b>Financing Cost Category</b>	<b>COP Project Financed At Completion (Assuming \$52,330,000 "Project" Budget)</b>	<b>COP Project Financed At Inception (Assuming \$52,330,000 "Project" Budget)</b>	<b>Actual Tumwater Financing (Assuming \$52,330,000 "Project" Budget)</b>	<b>Notes</b>
Underwriter's Discount	\$278,900.00	\$278,900.00	\$298,226.25	COP Underwriter's discount based on Treasurer estimate
Cost of issuance	\$155,500.00	\$155,500.00	\$805,432.21	COP Cost of Issuance based on Treasurer estimate
Capitalized Interest	\$0.00	\$6,224,477.03	\$6,385,584.37	COP capitalized interest on "financing at inception" based on Montague/DeRose analysis
Interest earnings	\$0.00	\$611,611.05	\$613,303.38	COP Interest earnings on "financing at inception" based on Montague/DeRose analysis
Construction financing	\$4,200,000.00	\$0.00	\$0.00	90% loan at 6.1% (LIBOR = 175 bps) plus 12% per annum to cash equity investor. Includes appraisal, title insurance 1% fee for lender and 1% fee for developer.
<b>Total Cost of Financing</b>	<b>\$4,634,400.00</b>	<b>\$6,047,265.98</b>	<b>\$6,875,939.45</b>	

<b>Total "Financed" Cost</b>	<b>\$57,014,800.00</b>	<b>\$58,427,665.98</b>	<b>\$57,954,339.45</b>
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**Assuming the Project Costs and Financing Costs Above - What Would Be The  
Annual Payments**

	<b>COP Project Financed At Completion (Assuming \$52,330,000 "Project" Budget)</b>	<b>COP Project Financed At Inception (Assuming \$52,330,000 "Project" Budget)</b>	<b>Actual Tumwater Financing (Assuming \$52,330,000 "Project" Budget)</b>
<b>Excel Based Annual Payment over 25 years at Hattori Interest Rate Differences</b>	<b>\$3,837,111.34</b>	<b>\$3,932,197.60</b>	<b>\$3,956,802.51</b>

**APPENDIX F**  
**EXCERPTS FROM THE STATE OF WASHINGTON**  
**COMPREHENSIVE ANNUAL FINANCIAL REPORT**  
**FOR THE FISCAL YEAR ENDED JUNE 30, 2005**



**STATE OF WASHINGTON**

# **COMPREHENSIVE ANNUAL FINANCIAL REPORT**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

**DECEMBER 2005**

## Notes to the Financial Statements

For the Fiscal Year Ended June 30, 2005

### Index to the Notes to the Basic Financial Statements

	Page
1. Summary of Significant Accounting Policies	
A. Reporting Entity .....	51
B. Government-wide and Fund Financial Statements .....	53
C. Measurement Focus and Basis of Accounting.....	55
D. Assets, Liabilities, and Net Assets or Equity .....	55
1. Cash and Investments.....	55
2. Receivables and Payables .....	56
3. Inventories.....	56
4. Capital Assets.....	56
5. Compensated Absences.....	57
6. Long-Term Liabilities .....	57
7. Fund Equity.....	58
E. Other Information .....	58
1. General Budgetary Policies and Procedures .....	58
2. Insurance Activities.....	58
3. Interfund/Interagency Activities .....	59
4. Donor-restricted Endowments.....	59
2. Accounting and Reporting Changes.....	60
3. Deposits and Investments.....	61
4. Receivables and Deferred/Unearned Revenues.....	79
5. Interfund Balances and Transfers.....	82
6. Capital Assets .....	86
7. Long-Term Liabilities .....	90
8. No Commitment Debt .....	99
9. Fund Balances Reserved for Other Specific Purposes.....	99
10. Deficit Net Assets.....	100
11. Retirement Plans .....	101
12. Commitments and Contingencies.....	120
13. Subsequent Events .....	124

## Note 7 – Long-Term Liabilities

### A. Bonds Payable

Bonds payable at June 30, 2005, are reported by the state of Washington within Governmental Activities and Business-Type Activities, as applicable.

The State Constitution and enabling statutes authorize the incurrence of state general obligation debt, to which the state's full faith, credit, and taxing power are pledged, either by the State Legislature or by a body designated by statute (presently the State Finance Committee). Legislative authorization arises from an affirmative vote of 60 percent of both legislative houses without voter consent, or from an affirmative vote of more than 50 percent of both legislative houses and a majority of the voters voting thereon. The State Finance Committee debt authorization does not require voter approval; however, it is limited to providing for: (1) temporary deficiencies in the state treasury (must be discharged within 12 months of the date of incurrence); (2) appropriations already made by the legislature; or (3) refunding of outstanding obligations of the state.

#### Legal Debt Limitation

The State Constitution and current statutes generally limit debt authorized in the preceding procedures. The limitations prohibit the issuance of new debt if it would cause the maximum annual debt service, on all thereafter-outstanding general obligation debt, to exceed a specified percentage of the arithmetic mean of general state revenues for the preceding three fiscal years. These limitations are on the incurrence of new debt, not on the amount of debt service that may be paid by the state in future years.

As certified by the State Treasurer, the maximum debt authorization subject to limitation for Fiscal Year 2005 was \$7.0 billion, under both the then current constitutional and statutory limitations. This computation excludes specific bond issues and types, which are not secured by general state revenues. Based

on the debt limitation calculation, the debt service requirements as of June 30, 2005, did not exceed the authorized debt service limitation.

#### Authorized but unissued

The state had a total of \$6.25 billion in bonds authorized but unissued as of June 30, 2005, for the purpose of public building and schools construction and renovation, higher education purposes, and highways construction and improvement.

#### Interest rates

Interest rates on fixed rate general obligation bonds ranged from 2.0 to 7.0 percent. Variable rate demand obligations (VRDO) of \$168.2 million as of June 30, 2005, are remarketed on a weekly basis. Interest rates on revenue bonds range from 1.5 to 7.4 percent.

#### DEBT SERVICE REQUIREMENTS TO MATURITY

**General obligation bonds** have been authorized and issued primarily to provide funds for:

- Acquisition and construction of capital facilities for public and common schools, higher education, public and mental health, corrections, natural resource conservation;
- Construction and improvements of highways, roads, bridges, ferries, and other transit improvements;
- Assistance to municipalities for construction of water and sewage treatment facilities and corrections facilities; and
- Refunding of general obligation bonds outstanding.

Outstanding general obligations bonds are presented in the Washington State Treasurer's Annual Report for 2005. A copy of the report is available from the Office of the State Treasurer, PO Box 40200, Olympia, Washington, 98504-0200, phone number (360) 902-9000 or TTY (360) 902-8963.

Total debt service requirements to maturity for general obligation bonds, as of June 30, 2005, are as follows (expressed in thousands):

General Obligation Bonds	Governmental Activities		Business-Type Activities		Totals	
	Principal	Interest	Principal	Interest	Principal	Interest
<b>By Fiscal Year:</b>						
2006	\$ 454,979	\$ 458,460	\$ 17,955	\$ 5,451	\$ 472,934	\$ 463,911
2007	458,153	452,986	19,150	4,436	477,303	457,422
2008	476,116	430,329	20,655	3,333	496,771	433,662
2009	483,150	408,970	11,335	4,899	494,485	413,869
2010	465,825	390,057	8,987	4,432	474,812	394,489
2011-2015	2,321,894	1,659,028	30,951	12,288	2,352,845	1,671,316
2016-2020	2,435,367	1,258,797	29,366	61,951	2,464,733	1,320,748
2021-2025	1,823,851	670,863	-	-	1,823,851	670,863
2026-2030	922,336	344,494	-	-	922,336	344,494
2031-2035	-	-	-	-	-	-
<b>Total Debt Service Requirements</b>	<b>\$ 9,841,671</b>	<b>\$ 6,073,984</b>	<b>\$ 138,399</b>	<b>\$ 96,790</b>	<b>\$ 9,980,070</b>	<b>\$ 6,170,774</b>

**Revenue Bonds** are authorized under current state statutes, which provide for the issuance of bonds that are not supported, or not intended to be supported, by the full faith and credit of the state. These bonds pledge income derived from acquired or constructed assets for retirement of the debt and payment of the related interest.

The Tobacco Settlement Authority (TSA), a blended component unit of the state, issued revenue bonds

secured by the TSA's right to receive 29.2 percent of the state's tobacco settlement revenue stream. These bonds are reported within governmental activities. The state's Colleges and Universities issue revenue bonds for the purpose of housing, dining, parking, and student facilities construction. These bonds are reported within governmental and business-type activities as applicable.

Total debt service requirements for revenue bonds to maturity as of June 30, 2005, are as follows (expressed in thousands):

Revenue Bonds	Governmental Activities		Business-Type Activities		Totals	
	Principal	Interest	Principal	Interest	Principal	Interest
<b>By Fiscal Year:</b>						
2006	\$ 110	\$ 35,128	\$ 13,934	\$ 28,631	\$ 14,044	\$ 63,759
2007	-	35,053	16,133	28,079	16,133	63,132
2008	13,270.0	34,977	16,836	27,361	30,106	62,338
2009	12,750	34,359	17,690	26,595	30,440	60,954
2010	12,400	33,741	18,196	25,690	30,596	59,431
2011-2015	86,640	156,587	108,003	114,913	194,643	271,500
2016-2020	103,085	126,415	129,682	87,973	232,767	214,388
2021-2025	120,280	91,171	126,726	58,131	247,006	149,302
2026-2030	153,860	50,037	95,651	29,331	249,511	79,368
2031-2035	61,180	4,605	42,382	5,157	103,562	9,762
<b>Total Debt Service Requirements</b>	<b>\$ 563,575</b>	<b>\$ 602,073</b>	<b>\$ 585,233</b>	<b>\$ 431,861</b>	<b>\$ 1,148,808</b>	<b>\$ 1,033,934</b>



## DEBT REFUNDINGS

When advantageous and permitted by statute and bond covenants, the State Finance Committee authorizes the refunding of outstanding bonds. When the state refunds outstanding bonds, the net proceeds of each refunding issue are used to purchase U.S. government securities that are placed in irrevocable trusts with escrow agents to provide for all future debt service payments on the refunded bonds. As a result, the refunded bonds are considered defeased and the liability has been removed from the government-wide statement of net assets.

## CURRENT YEAR DEFEASANCES

### Governmental Activities:

On May 3, 2005, the state issued \$343.6 million of Various Purpose General Obligation Refunding Bonds (Series R-2005A) with an average interest rate of 4.98 percent to refund \$341.6 million of Various Purpose General Obligation Bonds from several different series with an average interest rate of 5.80 percent. The refunding resulted in a \$40.7 million gross debt service savings over the next 20 years and an economic gain of \$31.2 million.

On May 3, 2005, the state issued \$95.8 million in Motor Vehicle Fuel Tax General Obligation Refunding Bonds (Series R-2005B) with an average interest rate of 4.14 percent to refund \$90.8 million of Motor Vehicle Fuel Tax General Obligation bonds from several series with an average interest rate of 5.64 percent. The refunding resulted in an \$11.8 million gross debt service savings over the next 20 years and an economic gain of \$8.6 million.

### Business-Type Activities:

On September 29, 2004, the University of Washington issued \$4.57 million in Parking System Revenue and Refunding Bonds (Series 2004) with an average interest rate of 3.43 percent to refund \$3.96 million of Parking System Revenue Bonds with an average interest rate of 6.13 percent. The refunding resulted in \$4 thousand gross debt service savings over the next 11 years and an economic loss of \$1 thousand.

On April 20, 2005, Washington State University issued \$16.3 million in Housing and Dining Services Revenue and Refunding Bonds (Series 2005) with an average interest rate of 4.45 percent, to refund \$14.73 million of

Housing and Dining Services Revenue Bonds with an average interest rate of 5.85 percent. The refunding resulted in a \$1.3 million gross debt service savings over the next 25 years and an economic gain of \$829 thousand.

On May 11, 2005, Washington State University issued \$8.84 million in Parking Services Revenue and Refunding Bonds (Series 2005), with an average interest rate of 4.12 percent, to refund \$7.99 million of Parking Services Revenue Bonds with an average interest rate of 5.71 percent. The refunding resulted in \$732 thousand gross debt service savings over the next 19 years and an economic gain of \$513 thousand.

On May 24, 2005, Western Washington University issued \$12.6 million in Housing and Dining Revenue and Refunding bonds (Series 2005), with an average interest rate of 3.88 percent, to refund \$11.2 million of Housing and Dining Revenue Bonds with an average interest rate of 5.71 percent. The refunding resulted in \$3.2 million gross debt service savings over the next 20 years and an economic gain of \$2.8 million.

On June 7, 2005, the University of Washington issued \$43.6 million in Student Facilities Fee Revenue and Refunding Bonds (Series 2005) with an average interest rate of 4.82 percent, to refund \$41.6 million of Student Facilities Fee Revenue Bonds with an average interest rate of 5.77 percent. The refunding resulted in \$3.6 million gross debt service savings over the next 25 years and an economic gain of \$2.1 million.

## PRIOR YEAR DEFEASANCES

In prior years, the state defeased certain general obligation and other bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the prior bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the state's financial statements.

### General Obligation Bond Debt:

On June 30, 2005, \$479.7 million of general obligation bonded debt outstanding is considered defeased.

### Revenue Bond Debt:

On June 30, 2005, \$69.5 million of revenue bonded debt outstanding is considered defeased.

## B. Certificates of Participation

Current state law authorizes the state to enter into long-term financing contracts for the acquisition of real or personal property and for the issuance of certificates of participation in the contracts. These certificates of participation do not fall under the general obligation debt

limitations and are generally payable only from annual appropriations by the Legislature. Other specific provisions could also affect the state's obligation under certain agreements. The certificates of participation are recorded for financial reporting purposes if the possibility of the state not meeting the terms of the agreements is considered remote.

Total debt service requirements for certificates of participation to maturity as of June 30, 2005, are as follows (expressed in thousands):

Certificates of Participation	Governmental Activities		Business-Type Activities		Totals	
	Principal	Interest	Principal	Interest	Principal	Interest
<b>By Fiscal Year:</b>						
2006	\$ 31,629	\$ 15,340	\$ 37,524	\$ 18,198	\$ 69,153	\$ 33,538
2007	25,456	12,324	16,291	10,389	41,747	22,713
2008	23,150	11,337	15,678	9,718	38,828	21,055
2009	25,087	10,418	18,960	9,052	44,047	19,470
2010	23,097	9,365	17,761	8,222	40,858	17,587
2011-2015	129,800	34,760	92,012	24,640	221,812	59,400
2016-2020	45,761	6,967	42,218	6,651	87,979	13,618
2021-2025	10,538	875	10,203	847	20,741	1,722
2026-2030	-	-	-	-	-	-
2031-2035	-	-	-	-	-	-
<b>Total Debt Service Requirements</b>	<b>\$ 314,518</b>	<b>\$ 101,386</b>	<b>\$ 250,647</b>	<b>\$ 87,717</b>	<b>\$ 565,165</b>	<b>\$ 189,103</b>

### C. Claims and Judgments

Claims and judgments are materially related to three activities: workers' compensation, risk management, and health insurance. Workers' compensation and health insurance are business-type activities, and risk management is a governmental activity. A description of the risks to which the state is exposed by these activities,

and the ways in which the state handles the risks, is presented in Note 1E.

#### Workers' Compensation

Changes in the balances of workers' compensation claims liabilities during Fiscal Years 2004 and 2005 were as follows (expressed in thousands):

	Balances Beginning of Fiscal Year	Incurred Claims and Changes in Estimates	Claim Payments	Balances End of Fiscal Year
<b>Workers' Compensation Fund</b>				
FY 2004	\$ 15,863,852	2,267,506	(1,540,260)	\$ 16,591,098
FY 2005	\$ 16,591,098	2,289,923	(1,602,126)	\$ 17,278,895

At June 30, 2005, \$30.6 billion of unpaid claims and claim adjustment expenses are presented at their net present and settlement value of \$17.3 billion. These claims are discounted at assumed interest rates of 2.5 percent (time loss and medical) to 6.5 percent (pensions) to arrive at a settlement value that is net of third party recoveries.

These COLA payments are funded on a pay-as-you-go basis, and the Workers' Compensation actuaries have indicated that future premium payments will be sufficient to pay these claims as they come due. The remaining claims liabilities of \$8.6 billion are fully funded by long-term investments, net of obligations under securities lending agreements.

The claims and claim adjustment liabilities of \$17.3 billion, as of June 30, 2005, include \$8.7 billion for supplemental pension cost of living adjustments (COLAs) that by statute are not to be fully funded.

#### Risk Management

Changes in the balances of risk management claims liabilities during Fiscal Years 2004 and 2005 were as follows (expressed in thousands):

	Balances Beginning of Fiscal Year	Incurred Claims and Changes in Estimates	Claim Payments	Tort Defense Payments	Balances End of Fiscal Year
<b>Risk Management Fund</b>					
FY 2004	\$ 498,914	59,882	(29,755)	(15,710)	\$ 513,331
FY 2005	\$ 513,331	34,857	(23,130)	(16,945)	\$ 508,113

Risk Management reports claims and judgment liabilities when it becomes probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an actuarially determined amount for claims that have been incurred but not reported. It also includes an actuarial estimate of loss adjustment expenses for tort defense. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines, and damage awards, it should be recognized that future loss emergence will likely deviate, perhaps materially, from the actuarial estimates. Claims liabilities are re-evaluated annually to take into consideration recently settled claims, the frequency of claims, and other economic or social factors.

The state is a defendant in a significant number of lawsuits pertaining to property and casualty matters. As of June 30, 2005, outstanding and actuarially determined claims against the state and its public authorities were \$508.1 million for which the state has recorded a liability. The state is restricted by law from accumulating funds in the Self Insurance Liability Program in excess of 50 percent of total outstanding and actuarially determined claims. At June 30, 2005, the Risk Management Fund held \$77.6 million in cash and pooled investments designated for payment of these claims under the state's Self Insurance Liability Program.



Health Insurance

Changes in the balances of Health Insurance claim liabilities during Fiscal Years 2004 and 2005 were as follows (expressed in thousands):

Health Insurance Fund	Balances	Incurring	Claim	Balances
	Beginning of	Claims and	Payments	End of
	Fiscal Year	Changes in		Fiscal Year
		Estimates		
FY 2004	\$ 47,934	431,539	(412,594)	\$ 66,879
FY 2005	\$ 66,879	524,106	(512,556)	\$ 78,429

The Health Insurance Fund establishes a liability when it becomes probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an actuarially determined amount for claims that have been incurred but not reported. Because actual claims liabilities depend on various complex factors, the process used in computing claims liabilities does not always result in an exact amount. Claims liabilities are re-evaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors.

At June 30, 2005, health insurance claims liabilities totaling \$78.4 million are fully funded with cash and investments, net of obligations under securities lending agreements

**D. Leases**

The state leases land, office facilities, office and computer equipment, and other assets under a variety of agreements. Although lease terms vary, most leases are subject to appropriation from the state Legislature to continue the obligation. If the possibility of receiving no funding from the Legislature is remote, leases are considered noncancelable for financial reporting purposes. Leases that represent acquisitions are classified as capital leases, and the related assets and liabilities are recorded in the financial records at the inception of the lease. Other leases are classified as operating leases with the lease payments recorded as expenditures or expenses during the life of the lease. Certain operating leases are renewable for specified periods. In most cases, management expects that the leases will be renewed or replaced by other leases.

Leased land, buildings and equipment under capital leases as of June 30, 2005, include the following (expressed in thousands):

	Governmental	Business-Type
	Activities	Activities
Land (non-depreciable)	\$ 1,918	\$ -
Buildings	4,258	6,271
Equipment	3,327	131
Less: Accumulated Depreciation	(1,927)	(944)
Totals	\$ 7,576	\$ 5,458



The following schedule presents future minimum payments for capital and operating leases as of June 30, 2005, (expressed in thousands):

Capital and Operating Leases	Capital Leases		Operating Leases	
	Governmental Activities	Business-Type Activities	Governmental Activities	Business-Type Activities
<b>By Fiscal Year:</b>				
2006	\$ 6,397	\$ 3,969	\$ 113,429	\$ 25,556
2007	5,219	4,554	100,256	24,265
2008	3,204	4,264	81,230	21,862
2009	3,256	4,141	71,327	20,803
2010	2,565	1,887	61,675	20,406
2011-2015	5,362	2,821	198,651	96,461
2016-2020	550	1,925	83,608	94,500
2021-2025	137	816	69,856	98,000
2026-2030	-	-	56,589	103,000
2031-2035	-	-	43,731	120,000
<b>Total Future Minimum Payments</b>	<b>26,690</b>	<b>24,377</b>	<b>880,352</b>	<b>624,853</b>
<b>Less: Executory costs and interest costs</b>	<b>3,181</b>	<b>3,689</b>	<b>-</b>	<b>-</b>
<b>Net Present Value of future minimum lease payments</b>	<b>\$ 23,509</b>	<b>\$ 20,688</b>	<b>\$ 880,352</b>	<b>\$ 624,853</b>

The total operating lease rental expense for Fiscal Year 2005 was \$201.8 million.

## E. Long-Term Liability Activity

Long-term liability activity for the Fiscal Year 2005 (expressed in thousands) was as follows:

	Beginning Balance July 1, 2004	Additions	Reductions	Ending Balance June 30, 2005	Amounts Due Within One Year
<b>Governmental Activities:</b>					
Long-term Debt:					
GO Bonds Payable -					
General obligation (GO) bonds	\$ 8,522,375	1,413,295	838,990	\$ 9,096,680	\$ 443,245
GO - zero coupon bonds (principal)	651,006	110,002	16,017	744,991	11,734
Subtotal - GO Bonds payable	9,173,381	1,523,297	855,007	9,841,671	454,979
Accreted Interest - GO - zero coupon bonds	178,241	22,817	-	201,058	-
Revenue Bonds Payable	510,655	60,720	7,800	563,575	110
Less: Deferred amounts for issuance discounts	(12,770)	-	(773)	(11,997)	-
Less: Unamortized bond issuance costs	(2,152)	-	(131)	(2,021)	-
Total Bonds Payable	9,847,355	1,606,834	861,903	10,592,286	455,089
Other Liabilities -					
Certificates of participation	274,061	74,199	33,742	314,518	31,629
Claims and judgments	583,332	173,509	156,255	600,586	111,267
Installment contracts	221	-	110	111	111
Leases	27,743	680	4,914	23,509	6,397
Compensated absences	412,295	294,192	268,239	438,248	42,408
Unfunded pension obligations	55,500	11,725	-	67,225	-
Other	124,831	344,173	362,613	106,391	102,434
Total Other Liabilities	1,477,983	898,478	825,873	1,550,588	294,246
<b>Total</b>	<b>\$11,325,338</b>	<b>2,505,312</b>	<b>1,687,776</b>	<b>\$ 12,142,874</b>	<b>\$ 749,335</b>

For Governmental Activities, payments on the certificates of participation are being repaid directly from various governmental funds. The compensated absences liability will be liquidated approximately 53 percent by the General Fund, 24 percent by the Higher Education Special Revenue Funds, and the balance by various other governmental funds. The claims and judgments liability will be liquidated primarily through the risk management fund, an internal service fund. Leases, installment contract obligations, and other liabilities will be repaid from various other governmental funds.

Revenue bonds outstanding at June 30, 2005 of \$502.9 million were issued by the Tobacco Settlement Authority (TSA), which is a blended component unit of the state. The bonds are obligations of the TSA and are secured solely by the TSA's right to receive 29.2 percent of the state's tobacco settlement revenues, restricted investments of the TSA, and undistributed TSA bond proceeds. These bonds do not constitute either a legal or moral obligation of the state, nor does the state pledge its full faith, credit or taxing power for payment of these bonds.

State of Washington

	Beginning Balance July 1, 2004	Additions	Reductions	Ending Balance June 30, 2005	Amounts Due Within One Year
<b>Business-Type Activities</b>					
Long-term Debt:					
GO Bonds Payable					
General obligation (GO) bonds	\$ 126,100	-	16,960	\$ 109,140	\$ 17,955
GO - zero coupon bonds (principal)	29,259	-	-	29,259	-
Subtotal - GO Bonds payable	155,359	-	16,960	138,399	17,955
Accreted Interest - GO - zero coupon bonds	20,744	3,092	-	23,836	-
Revenue Bonds Payable	520,179	144,470	79,416	585,233	13,934
Less: Deferred amounts on refunding	(3,891)	(5,790)	(273)	(9,408)	-
Plus: Unamortized amounts issuance premiums	1,616	4,833	2,734	3,715	-
Less: Deferred amounts for issuance discounts	(1,638)	(522)	(313)	(1,847)	-
Less: Unamortized bond issuance costs	(1,742)	(544)	(236)	(2,050)	-
Total Bonds Payable	690,627	145,539	98,288	737,878	31,889
Other liabilities -					
Certificates of participation	246,550	9,530	5,433	250,647	37,524
Less: Deferred amounts for issuance discounts	(1,904)	146	(1)	(1,757)	-
Claims and judgments	16,661,334	2,303,849	1,603,918	17,361,266	1,675,438
Lottery prize annuities payable	498,034	37,503	74,777	460,760	68,705
Tuition benefits payable	462,294	157,397	18,402	601,289	-
Leases	14,245	17,415	10,972	20,688	3,969
Compensated absences	41,564	24,591	20,840	45,315	17,986
Other	32,501	51,901	64,968	19,433	18,751
Total Other Liabilities	17,954,618	2,602,332	1,799,309	18,757,641	1,822,373
<b>Total</b>	<b>\$18,645,245</b>	<b>2,747,871</b>	<b>1,897,597</b>	<b>\$ 19,495,519</b>	<b>\$ 1,854,262</b>

## Note 12 - Commitments and Contingencies

### A. Construction and Other Commitments

Outstanding commitments related to state infrastructure and facility construction, improvement, and/or renovation totaled \$2.26 billion at June 30, 2005.

### B. Summary of Significant Litigation

The state and its agencies are parties to numerous routine legal proceedings that normally occur in governmental operations. At any given point, there may be numerous lawsuits involving state agencies that could impact expenditures. There is a recurring volume of tort and other claims for compensation and damages against the state and some specific state agencies, including the Departments of Transportation, Corrections, Social and Health Services, and the University of Washington. A significant portion of pending litigation relates to the implementation of specific state programs, and funds are reserved each biennium for handling this litigation. The collective impact of these claims, however, is not likely to have a material impact on state revenues or expenditures.

#### Social and Health Services

During the reporting period, there have been additional challenges or developments in pending cases involving the administration of state social service programs. These include:

*Arc of Washington v. Braddock.* This is a class action lawsuit pending in the U.S. District Court. Plaintiffs allege that Medicaid eligible developmentally disabled clients are not receiving adequate services under state and federal Medicaid law. An additional class of plaintiffs failed to successfully intervene in the Arc case. Those plaintiffs have filed a related case in federal court entitled *Boyle v. Arnold Williams, et al.* A potential award based on the biennial cost of providing the services sought in these lawsuits was originally estimated at approximately \$165 to \$222 million. An intermediate ruling of the Ninth Circuit Court of Appeals, however, stated that plaintiffs had no right under the Americans with Disabilities Act to be placed on the State's Medicaid waiver program. This ruling significantly reduced the potential exposure, but an updated figure has not been developed.

*Pierce County, et al v. DSHS, et al.* This is a case pending in Thurston County Superior Court. Plaintiffs seek injunctive relief and damages associated with an alleged failure on the part of the State to provide greater services at Western State Hospital (WSH) to persons who are civilly committed under the State's mental health laws. In late November, the trial court issued an oral ruling requiring WSH to promptly accept civilly

committed patients or reimburse Pierce County for their care. The county also claimed breach of contract pertaining to the formulation of the contracts establishing Medicaid rates between 2001 and 2005 and asserted that the State illegally required Pierce County to use Medicaid savings to provide services to non-Medicaid eligible individuals. The trial court rejected these latter two claims. The oral ruling has not yet been reduced to an order, and appeals will be considered. New program costs alone could be as much as \$5 million annually, and there will likely be some damages awarded.

*Braam v. State.* This class action is pending in Whatcom County Superior Court. Plaintiffs seek both damages and injunctive relief on behalf of all foster children with three or more placements. The original verdict was set aside on appeal and a new trial was ordered. As part of a pretrial mediation stipulation the State agreed to supplement its child welfare reform plan in six areas identified in Plaintiff's complaint. A five member panel is overseeing these settlement activities. Based on the current recommendations of the panel, estimated additional program costs will be at least \$50 million. The panel's initial report setting forth benchmarks, professional standards, and action steps was released in late November 2005.

*Townsend v. Braddock.* In this federal class action lawsuit, Plaintiff class seeks declaratory and injunctive relief under the Americans with Disabilities Act establishing a substantial expansion of eligibility for elderly persons for certain home and community based care programs. The case is currently stayed while the parties attempt to reach a settlement. Potential costs are not yet quantifiable but, due to the small number of eligible clients, will probably not exceed \$5 million per year.

*Capital Medical Center, et al. v. DSHS.* This is a class action pending in Thurston County involving various hospitals formerly participating in the Medically Indigent Program. Plaintiffs allege that the Department improperly deducted as much as \$2,000 for every patient treated under the program. On summary judgment the Department failed to establish that it had the authority to engage in these deductions. The case is proceeding to final judgment on two other remaining issues. Potential damages could reach as much as \$20 million depending on the exact terms of the final judgment.

*Group Health Cooperative v. DSHS.* In this Thurston County case, Group Health claims that the Department breached certain managed care contracts between 1992 and 2001 by failing to identify and decertify persons simultaneously receiving other public benefits while



enrolled in the Group Health Plan. There is no trial date set. Potential damages have been estimated at \$14.6 million.

#### Transportation

*Lower Elwha Klallam Tribe, et al. v. WSDOT, et al.* Plaintiff Tribes have brought suit in Thurston County Superior Court alleging that the Washington State Department of Transportation and the State Department of Archaeology and Historic Preservation negligently disturbed a significant archaeology site during construction of a graving dock near Port Angeles. The complaint seeks cash damages and injunctive relief. The complaint does not specify the amount of damages sought but negotiations have indicated that the Tribe's claim exceeds \$5 million. The court stayed the litigation until January 2006 to enable the parties to pursue settlement negotiations.

*U.S. v. Washington.* In this federal court lawsuit, various Tribes seek significantly accelerated remediation schedules associated with eliminating or replacing existing transportation structures that block fish passage. The State has already identified over \$200 million in remedial costs associated with the remediation of these structures. Absent litigation, WSDOT would address these costs over a 20 year period based on available resources. Additional costs are associated with repair of blocking culverts on forest roads under the control of state natural resource agencies. Trial is scheduled for March of 2007.

*Squaxin Tribe and Swinomish Tribe v. Stephens and Department of Licensing.* In this case the Plaintiff Tribes seek a federal court injunction prohibiting the imposition of the state gas tax on gasoline sales at tribally owned gas stations. The Tribes rely primarily on various federal pre-emption theories to support their claim. The Federal District Court recently ruled that the incidence of the state tax was on the tribal retailers and that therefore, the state tax was pre-empted. If upheld on appeal, this ruling for the two Plaintiff Tribes will likely reduce fuel tax revenues by at least \$400,000 per year. A more significant impact on fuel tax revenues will follow if other Tribes seek similar exemptions based on this case.

*Commencement Bay Superfund Site.* The State of Washington was named a potentially responsible party in 1990 for sediment contamination at the Thea Foss Waterway in Tacoma. Seventy parties have assigned their claims against the State to three major utilities. The cleanup costs are estimated at approximately \$60 million.

*United States v. WSDOT & Southgate.* A federal court action under federal environmental law seeking restitution to the U.S. Environmental Protection Agency (EPA) arising from remediation of a contaminated well

field in Tumwater. The lawsuit alleges that the WSDOT materials lab was the source of the contamination. The EPA seeks \$11 million.

#### Personnel

*Davis, et al. v. DOT.* This lawsuit involves 400 class members who are current or former employees of the Washington State Ferries. Plaintiffs work twelve hour shifts on seven day intervals. Oncoming crews relieve retiring crews during their shift so there is no gap between shifts. Plaintiffs rely on two different wage recovery statutes, Department of Labor and Industries regulations and collective bargaining agreements, to seek additional compensation for the work performed during shift overlap periods. The claims of Plaintiff Class will likely exceed \$12 million. Trial is scheduled for February of 2006.

#### Revenue

There is a recurring volume of lawsuits seeking refunds of taxes paid to the state. All are not reported here.

*Estate of Hemphill.* Class Plaintiffs prevailed in the Washington State Supreme Court on a claim involving the state estate tax in relation to the federal inheritance tax. The State must reimburse Class Plaintiffs for taxes collected under the state estate tax. The total amount of refunds is \$167.7 million, of which \$137.5 million was paid in Fiscal Year 2005.

*Microsoft Corp. v. Department of Revenue.* Microsoft seeks a refund of deferred sales and use taxes alleging that it does not owe such tax on retained software or software not sold for profit. Microsoft seeks a refund of at least \$16 million, plus statutory interest.

*Qwest Corp. v. Department of Revenue.* Qwest seeks property tax refunds alleging that the Department's valuations of its operating property in Washington between 2001 and 2004 were excessive. The Department estimates that Qwest's refund claims total approximately \$55 million, plus statutory interest. Trial is scheduled to begin on February 14, 2006.

*Texaco Refining and Marketing, Inc. v. Department of Revenue.* Texaco alleges that the Department overvalued exchanges of petroleum products it made with other oil companies. This case is currently on appeal to the Washington State Court of Appeals. Texaco seeks refunds of B&O, Hazardous Substances, and Petroleum Products Taxes totaling \$5.7 million, plus statutory interest.

*Washington State Farm Bureau Federation, et al. v. Gregoire.* This action pending in Snohomish County Superior Court challenges the validity of revenue measures enacted by the 2005 Legislature, including sales and use tax on extended warranties, cigarettes and

liquor, and a tax on the transfer of decedents' estates. Revenues from these measures for the 2005-2007 biennium are projected to be approximately \$401 million.

#### Education

*School Districts' Alliance for Adequate Funding of Special Education, et al. v. State of Washington, et al.* Plaintiffs challenge the Legislature's method and adequacy of funding for special education based on a flat, per capita rate per eligible student and the limitation of excess funding to 12.7 percent of the total district student population. Trial is scheduled for October of 2006. Additional costs resulting from a ruling in plaintiffs' favor would be as much as \$360 million per biennium.

#### General Government

*Washington Public Employees Association v. State; and, Shroll v. State.* A consolidated class action suit brought on behalf of state employees in "common classes," general government agencies and higher education institutions under the jurisdiction of the Personnel Resources Board. Plaintiffs seek back pay and prospective wage adjustments to rectify alleged discrepancies between the highest and lowest salaries within the common class. Plaintiffs prevailed in the State Court of Appeals and the State has sought Supreme Court review. Plaintiffs seek at least \$67 million in back pay and \$7 million a year in prospective wage adjustments. Wage claim statutes allow for double damages in certain circumstances so the \$67 million could become \$134 million.

#### Natural Resources

*WEC v. Sutherland.* This case involves judicial review of the adequacy of a Final Environmental Impact Statement (FEIS) for the Board of Natural Resources and Department of Natural Resources' decision establishing a new sustainable harvest level for DNR-managed forested lands in Western Washington. This harvest level set in September 2004 would have averaged 597 MMBF/year (million board feet per year) over the 2005-2014 decade, estimated to result in a net revenue of \$151 million per year. The King County Superior Court found the FEIS to be inadequate. No final order has been entered as of this writing.

Should an order be entered and upheld consistent with the Judge's memorandum decision, the September 2004 harvest level for Western Washington would be invalidated, a revised EIS would need to be developed, and a new harvest level decision based on the revised EIS would be required. The short-term impact of this decision will be to return harvest levels to the no action alternative, which is estimated to result in net revenue of \$121 million per year over the planning decade, or about \$30 million less per year than the harvest level set in

2004. The Department estimates it would take two years to prepare the needed additional environmental and economic analyses. The long-term impact will depend on any new harvest level decision.

*ASARCO Bankruptcy.* ASARCO filed for Chapter 11 bankruptcy on September 9, 2005. ASARCO's smelter operation in Tacoma/Ruston is a Superfund site under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). The "Groundwater/Sediments Unit" of the Superfund site includes about 110 acres of state-owned aquatic land. The primary contaminants of aquatic lands are arsenic and copper. Under CERCLA, the State is also a Potentially Responsible Party (PRP) because it owns the contaminated property and the State could be responsible for much of the cost of clean up if ASARCO evades liability through bankruptcy. The U.S. Environmental Protection Agency (EPA) currently estimates the cost of clean up for the entire site at \$22 million. The clean up of state-owned aquatic lands is estimated at \$11 million.

#### Tort Cases and Claims

*Stephen Joyce v. DOC.* Parolee, on a suspended driver's license, killed a young mother. The jury found for the plaintiff in September 2000 and Department of Corrections (DOC) appealed. The Court of Appeals, Division II, affirmed. The Washington State Supreme Court affirmed in part, reversed in part, and remanded to the trial court for further proceedings thereby overturning the nearly \$22.5 million verdict. The State sought a ruling from the Supreme Court to limit DOC's liability for crimes unrelated to conditions of supervision of prior offenses, but was unsuccessful. Motions for Reconsideration filed by both parties are still pending in the Supreme Court.

*Thelma Taylor/Amanda Morgan-Hayes/Karen Peterson v. DOC.* Plaintiffs, in three separate lawsuits, claim substantial damages because DOC allegedly failed to properly assess and supervise offender Michael J. Braae. The case is stayed, with no trial date yet set. This case is significant because if the State is found liable for negligent supervision of Michael J. Braae the combined damages to his numerous victims will be substantial.

*Aba Sheikh v. DSHS.* Plaintiff was assaulted by four assailants, two of whom were dependent children in foster care. The jury awarded over \$10 million, finding DSHS liable for about \$8 million of the total. Department of Social and Health Service's (DSHS) appeal was certified for direct review by the State Supreme Court, which heard oral argument on June 9, 2005, and has yet to render a decision. (Note: the Court of Appeals, in *Terrell C. v. DSHS* (2004), review denied 2005, held that the purpose of DSHS's duty to control children was to protect the children, and not to protect third persons. The *Aba Sheikh* case, if allowed to stand,



would conflict with and constitute a reversal of Terrell C., creating a new cause of action against DSHS.)

*Daniel Albertson, GAL v. DSHS and Ronald Young.* Ronald Young was arrested and pled guilty to sexually abusing his foster children, which he photographed and posted on the internet. The present lawsuit involves seven allegedly injured children. The AGO is obtaining investigative reports from the criminal action. This matter is significant because potential damages exposure could be substantial if liability is proven against the State for placing children in his care.

*WSP and Officer Idland.* Trooper Idland is accused of sexually molesting female motorists after he pulled them over for driving under the influence of intoxicants. There are currently eight tort claims filed, with additional claims likely. Idland pled guilty to custodial sexual misconduct. Plaintiffs are claiming negligent hiring, retention, and supervision by the WSP. If the claims are successful, damages could be substantial.

### C. Federal Assistance

The state has received federal financial assistance for specific purposes that are generally subject to review or audit by the grantor agencies. Entitlement to this assistance is generally conditional upon compliance with the terms and conditions of grant agreements and applicable federal regulations, including the expenditure of assistance for allowable purposes. Any disallowance resulting from a review or audit may become a liability of the state. The state does estimate and recognize a claims and judgments liability for disallowances when determined by the grantor agency or for probable disallowances based on experience pertaining to these grants; however, these recognized liabilities and any unrecognized disallowances are considered immaterial to the state's overall financial condition.

### D. Arbitrage Rebate

Rebatable arbitrage is defined by the Internal Revenue Service Code Section 148 as earnings on investments purchased from the gross proceeds of a bond issue that are in excess of the amount that would have been earned if the investments were invested at a yield equal to the yield on the bond issue. The rebatable arbitrage must be paid to the federal government. State agencies and universities responsible for investments from bond proceeds carefully monitor their investments to restrict earnings to a yield less than the bond issue, and therefore limit any state arbitrage liability. The state estimates that rebatable arbitrage liability, if any, will be immaterial to its overall financial condition.

### E. Other Commitments and Contingencies

#### School Bond Guarantee Program

Washington voters passed a constitutional amendment in November 1999, creating the Washington State School Bond Guarantee Program. The program's purpose is to provide savings to state taxpayers by pledging the full faith and credit of the state of Washington to the full and timely payment of voter-approved school district general obligation bonds in the event a school district is unable to make a payment. The issuing school district remains responsible for the repayment of the bonds, including any payment the state makes under the guarantee.

The State Treasurer introduced the School Bond Guarantee Program in March 2000. At the end of Fiscal Year 2005, the state had guaranteed 172 school districts' voter-approved general obligation debt with a total outstanding principal of \$4.6 billion. The state estimates that school bond guarantee liability, if any, will be immaterial to its overall financial condition.

#### Local Option Capital Asset Lending Program (LOCAL)

On September 1, 1998, the state lease-purchase program, was extended to local governments seeking low cost financing of essential equipment. The program allows local governments to pool their financing requests together with Washington State agencies in Certificates of Participation (COPs). Refer to Note 7.B for the state's COP disclosure. These COP's do not constitute a debt or pledge of the faith and credit of the state, rather local governments pledge their full faith and credit in a general obligation pledge. In the event that any local government fails to make any payment, the state is obligated to withhold an amount sufficient to make such payment from the local government's share, if any, of state revenues or other amounts authorized or required by law to be distributed by the state to such local government, if otherwise legally permissible. Upon failure of any local government to make a payment, the state is further obligated, to the extent of legally available appropriated funds to make such payment on behalf of such local government. The local government remains obligated to make all COP payments and reimburse the state for any conditional payments.

As of June 30, 2005, outstanding certificates of participation notes totaled \$53.5 million for 220 local governments participating in LOCAL. The state estimates that LOCAL program liability, if any, will be immaterial to its overall financial condition.

#### Office Building Lease

The 2001 Legislature authorized the state to lease-develop an office building in Tumwater, Washington. On October 23, 2003, the state entered into a ground lease and a lease agreement with Tumwater Office Properties (TOP), a Washington nonprofit corporation. The agreements call for TOP to design and construct an office building and to finance it with tax-exempt obligations that meet the requirements of Revenue Ruling 63-20 and Revenue Procedure 82-26 issued by

the Internal Revenue Service. The state is required to make monthly payments that equal the required debt service on the bonds. Additional amounts may also be due per the terms of the lease agreement. The lease agreements provide the state with options to purchase the building during the term of the lease and transfer ownership of the building to the state at the end of the lease. The office building was occupied starting in early fiscal year 2006.

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### **Note 13 - Subsequent Events**

#### **A. Bond Issues**

In July 2005, the state refunded \$461.2 million in Various Purpose General Obligation bonds, series R-2006A.

In August 2005, the state issued \$64.2 million in General Obligation Taxable Bonds, Series 2006T.

In August 2005, the state issued \$229.9 million in Various Purpose General Obligation Bonds, Series 2006A and \$197 million in Motor Vehicle Fuel Tax General Obligation Bonds, Series 2006B.

In September 2005, the state issued \$55 million in Motor Vehicle Fuel Tax General Obligation Bonds, Series 2006C.

#### **B. Certificates of Participation**

In August 2005, the state issued \$16.6 million in Certificates of Participation for various state and local government real estate purchases, Series 2005D.

In August 2005, the state issued \$6.8 million in Certificates of Participation for various state and local government equipment purchases, Series 2005E.

In December 2005, the state plans to issue \$11 million in Certificates of Participation for various state and local government equipment purchases, Series 2005F.



## APPENDIX G

### BOARDS OF DIRECTORS OF WASHINGTON 63-20s

63-20s Nonprofit Boards 63-20 Transactions from 01/01/00 - 08/31/05			
Entity	Issuer	Asset Manager	Boards
City of Redmond	Redmond Community Properties	NDC*	Robert W. Davenport, President and Chairman of the Board of Directors Sara Loveland, Treasurer and Director Ingrid Nardoni, Secretary and Director John A. Finke, Vice President Charley F. (Chuck) Depew, Vice President
Department of General Administration	Tumwater Office Properties	NDC*	Robert W. Davenport, President and Chairman of the Board of Directors John A. Finke, Vice President Sara Loveland, Treasurer and Director Ann Vogt, Secretary and Director
Highlands Sewer District, King County	Highlands Community Facilities Association		Preston Sargent, President Lyn Manley, Vice President-Treasurer John D. Delafield, Secretary
King County	Broadway Office Properties	NDC*	Robert W. Davenport, President and Chairman of the Board of Directors John A. Finke, Vice President Sara Loveland, Secretary/Treasurer and Director Ingrid Nardoni, Director
King County	Goat Hill Properties	NDC*	Robert W. Davenport, President and Chairman of the Board of Directors John A. Finke, Vice President and Director Ann Vogt, Secretary-Treasurer and Director
University of Washington	Radford Court Properties	NDC*	Robert W. Davenport, Chairman of the Board of Directors and President Ann Vogt-Kopczynski, Director and Secretary Haazim Rashed, Director and Treasurer John A. Finke, Vice President
University of Washington	University of Washington Alumni Association		John Buller, Executive Director Gunn Cooper, Finance Director
University of Washington	25th Avenue Properties	NDC*	Robert W. Davenport, Chairman of the Board of Directors and President Ann Vogt, Sirector and Secretary-Treasurer Ingrid Nardoni, Director Paul F. Brown, Director John A. Finke, Vice President

\* National Development Council